A Study of Institutional Forces Concerned with Financial Accounting in the United States, Utilizing the Annual Reports of the United States Steel Corporation as Reference Points

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A STUDY OF INSTITUTIONAL FORCES CONCERNED WITH
FINANCIAL ACCOUNTING IN THE UNITED STATES,
UTILIZING THE ANNUAL REPORTS OF THE
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The purpose of the study was to trace and assess the institutional forces which have been concerned with financial accounting in the United States from 1902 to 1969, utilizing the annual reports of the United States Steel Corporation as reference points. Since the United States Steel Corporation was founded in 1901 and has been confronted with many of the financial accounting problems of the United States during the years from 1902 to 1969, the financial accounting of the United States Steel Corporation from 1902 to 1969 should closely parallel the development of financial accounting in the United States from 1902 to 1969. A sample of such financial accounting problems included valuation and stock watering, the doctrine of

conservatism, special problems of wartime financial accounting during the two world wars and the Korean Conflict, the interpretation of generally accepted accounting principles, the financial accounting adaptations to depression conditions, the use of the lifo inventory method, the effect of inflation, especially during the mid and late 1940's, the equating of pension expense with pension funding, the treatment of the investment credit, and deferred income taxes. The writer chose various accounting groups, the New York Stock Exchange, financial writers and financial services, labor unions, stockholders, and the federal government as the major groups of institutional forces concerned about financial accounting in the United States.

In pursuing the tracing and assessing of the institutional forces which have been concerned with financial accounting in the United States from 1902 to 1969, utilizing the annual reports of the United States Steel Corporation as reference points, the writer was concerned with the influences on financial accounting by various groups of institutional forces and with the utilization of financial accounting by the management of the United States Steel Corporation to further management's own goals. He was also concerned with drawing implications from the study for present-day financial accounting.

The study indicated that stockholders, labor unions,

and the New York Stock Exchange were not major factors in the development of the United States Steel Corporation statements. It was indicated that accounting groups and writers, financial writers and financial services, and the federal government were major factors in the development of the United States Steel Corporation statements. It was also stressed that no longer could the American Institute of Certified Public Accountants and the Securities and Exchange Commission disclaim responsibility for deficiencies in financial accounting. The management of the United States Steel Corporation also has played a very important role in the statements of the United States Steel Corporation. The writer concluded that the management of the United States Steel Corporation has tended to be a positive force in disclosure to stockholders and in choosing accounting methods that generally lowered net income in the year of the choice.

The writer drew implications from the study for present-day financial accounting in such matters as the possible reorientation of financial accounting to financial analysts, the effect of federal income taxation on financial accounting, the maintenance of "independence" in the public's eye in view of accounting groups and writers lobbying in favor of industry, and the relationship between the American Institute of Certified Public Accountants and the Securities and Exchange Commission. Impli-

cations were also drawn on the questions of compliance of the United States Steel Corporation to past American Institute of Accountants-American Institute of Certified Public Accountants promulgations, of management's freedom to improvise in financial accounting, and of the allowing of engineering-oriented experts to determine the amount of yearly depreciation.

CHAPTER I

INTRODUCTION TO THE PROBLEM

The Problem

Financial accounting[1] emerged as a control device for stockholders during the trust movement from 1898 to 1902. Since the United States Steel Corporation was founded in 1901 and has been confronted with many of the financial accounting problems of the United States during the years from 1902[2] to 1969, the financial accounting of the United States Steel Corporation from 1902 to 1969 should closely parallel the development of

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[1]Financial accounting is here defined as the accounting principles, practices, presentations, and terminologies employed in the formal statements of annual reports.

[2]The year 1902 is utilized because it was the first full year of operations for the United States Steel Corporation and was the year of the first full-year annual report.

financial accounting in the United States from 1902 to 1969. For instance, George O. May held that the 1902 Annual Report of the United States Steel Corporation was a landmark for financial accounting in this country.[3] A sample of such financial accounting problems includes valuation and stock watering, the doctrine of conservatism, special problems of wartime financial accounting during the two world wars and the Korean Conflict, the interpretation of generally accepted accounting principles, the financial accounting adaptations to depression conditions, the use of the lifo inventory method, the effect of inflation especially during the mid and late 1940's, the equating of pension expense with pension funding, the treatment of the investment credit, and deferred income taxes.

The purpose of the study is to trace and assess the institutional forces which have been concerned with financial accounting in the United States from 1902 to 1969, utilizing the annual reports of the United States Steel Corporation as reference points. The study

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[3] George O. May, Financial Accounting: A Distillation of Experience (New York: Macmillan Company, 1943), p. 54.

portrays how financial accounting in the United States arrived at its present state as the resultant of various institutional forces. Certain rather specific questions were raised in the mind of the writer during the preparation of the study. Some of these questions are now stated.

Accounting professional bodies have issued formal pronouncements from the 1930's to the present. Were there accounting forces which provided guidance for financial accounting before that time? Have the formalized pronouncements by the accounting professional bodies been effective in achieving compliance? The influence of the New York Stock Exchange on financial statements is sometimes considered in financial accounting circles as originating during the late 1920's and the depression of the 1930's. Did the New York Stock Exchange affect financial accounting before this time? Since the topic of this work is financial accounting, what has been the influence of financial writers and financial services on accounting statements?

Labor unions are the collective bargaining agents for many United States firms. Since union wage demands have been said, at times, to be limited by the profit position of the company, have labor unions applied pressure

to have profits determined by financial accounting methods which would yield a higher profit? If so, were these pressures on financial accounting effective? Financial accounting is considered as being oriented towards the stockholders. It is to them that financial accounting statements are often said to be issued. What influences on accounting were brought to bear by stockholders? What success have they had?

Financial accounting has sometimes been depicted as being free of federal government intervention for the first three decades of the 20th century and limited by federal government intervention since then. Were there no federal government influences on financial accounting matters during the first thirty years of the 20th century? Has financial accounting been severely limited by the federal government since then?

Accounting writers, the American Institute of Certified Public Accountants, the Securities and Exchange Commission, and the New York Stock Exchange have held that

the statements of a firm are those of its management.[4] A recent article questioned this assumption. Herbert E. Miller felt that the statements were not really management's, but neither were they the certified public accountants' nor the Securities and Exchange Commission's.[5] One might, therefore, ask "Whose statements are they?" To what extent has the management of the United States Steel Corporation been molded by various accounting institutional influences in financial

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[4] Louis H. Rappaport, SEC Accounting Practice and Procedure (New York: Ronald Press Company, 1956), p. 23; Walter B. Meigs and F. John Larsen, Principles of Auditing (4th ed.; Homewood, Illinois: Richard D. Irwin, Inc., 1969), p. 14; The American Institute of Certified Public Accountants, Responsibilities and Functions of the Independent Auditor in the Examination of Financial Statements, Statement on Auditing Procedure No. 30 (New York: The American Institute of Certified Public Accountants, 1960), p. 40; The American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins: Final Edition (New York: The American Institute of Certified Public Accountants, 1961), p. 10; The United States Securities and Exchange Commission, Accounting Series Releases: Compilation of Releases 1 to 112 Inclusive (Washington, D. C.: Government Printing Office, 1969), p. 108; G. Keith Funston, "Financial Reporting for the Investor " (remarks before the Executive Committee of the American Petroleum Institute, February 2, 1967), p. 3.

[5] Herbert E. Miller, "Audited Statements--Are They Really Managements's?" The Journal of Accountancy, 118 (October, 1964), 46.

accounting matters? Has the United States Steel Corporation's management taken financial accounting positions on its own initiative? Has the initiative of the United States Steel Corporation's management in financial accounting matters decreased as more formal promulgations have been issued by accounting professional bodies and governmental agencies? Has the utilization of financial accounting by the United States Steel Corporation's management created overconfidence[6] among stockholders?

As late as 1929, John B. Canning regarded the balance sheet as the focal point for accountants.[7] However, by 1932, a committee of the American Institute of Accountants held that the income statement had become the crucial fact in the valuation of an enterprise and was,

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[6] The writer assumes that overconfidence is created when management chooses a financial accounting procedure which increases net income in the year of the choice. Such an increase in net income may be the reason why existing stockholders do not sell their stock.

[7] John B. Canning, The Economics of Accountancy: A Critical Analysis of Accounting Theory (New York: Ronald Press Company, 1929), p. 179.

henceforth, far more important than the balance sheet.[8] This latter position has been reiterated in the years following 1932.[9] Was there a relatively sudden shift of emphasis from the balance sheet to the income statement in the early 1930's?

In pursuing the tracing and assessing of the institutional forces which have been concerned with financial accounting in the United States from 1902 to 1969, utilizing the annual reports of the United States Steel Corporation as reference points, the writer is concerned with the influences on financial accounting by various groups of institutional forces and with the

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[8]The American Institute of Accountants, Audits of Corporate Accounts: Correspondence between the Special Committee on Co-operation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange, 1932-1934 (New York: American Institute of Accountants, 1934), p. 8.

[9]George O. May, "The Nature of the Financial Accounting Process," The Accounting Review, 18 (July, 1943), 191; William J. Vatter, The Fund Theory of Accounting and its Implications for Financial Reports (Chicago: University of Chicago Press, 1947), p. 74; Charles T. Horngren, "Security Analysts and the Price Level," The Accounting Review, 30 (October, 1955), 576; Accounting Research and Terminology Bulletins, p. 7; Eldon S. Hendriksen, Accounting Theory (Homewood, Illinois: Richard D. Irwin, Inc., 1965), p. 51.

utilization of financial accounting by the management of the United States Steel Corporation to further management's own goals. He is also concerned with drawing implications from the study for present-day financial accounting and with the validity of certain rather prevalent generalities, such as the financial statements are those of management and the alleged primacy of the balance sheet prior to the 1930's, which are all too often asserted in the literature of financial accounting.

The Scope

The topic "financial accounting" means that "public utility accounting" is not discussed in the work. This work is not a study of the internal accounting policies, practices, and procedures of the United States Steel Corporation. The project is mainly limited to financial accounting in the United States, although there is some discussion of the English accounting profession in the 1890's and early 1900's, as English financial accounting was a standard for early United States financial accounting. The writer utilizes the term "management" as representative of corporate officers who have to bear the ultimate responsibility for financial accounting.

The writer chose the following as representative of the major groups of institutional forces[10] which were most concerned about financial accounting in the United States and were, therefore, possible influences upon financial accounting.

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[10] The term "institutional force" is here employed as meaning an organized societal unit with the power to effectuate action. This is, of course, an assumption.

1. Various Accounting Groups--Public Accounting firms, textbook authors, writers in accounting journals, the American Institute of Accountants, the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute, and the National Association of Accountants.
2. The New York Stock Exchange.
3. The Financial Writers and Financial Services.
4. The Labor Unions.
5. The Stockholders.
6. The United States Government. The federal agencies stressed in this project were the Treasury Department, the Internal Revenue Service, the United States Bureau of Corporations, the Federal Trade Commission, the Securities Exchange Commission, wartime governmental bodies, and different congressional committees.

Mention was also made of the National Association of Manufacturers' interest in simplifying annual reports and economists' interest in additional depreciation to match higher replacement costs of fixed assets.

The writer views these aforementioned groups as being external to the United States Steel Corporation. The management of the United States Steel Corporation is considered to be an internal force.

This study of the institutional forces affecting financial accounting in the United States from 1902 to 1969, utilizing the annual reports of the United States Steel Corporation as reference points, is not intended to be an all-inclusive history of United States financial accounting from 1902 to 1969. Since the United States Steel Corporation has been a very significant United States corporation in the main-stream of economic and industrial development and probably has been subject to as many of the institutional forces affecting United States financial accounting as any other corporation during this period, the utilization of the annual reports of the United States Steel Corporation is an acceptable starting point for the study. The basis for discussing the issues that are covered is delimited by the specifically enumerated sources. While it is felt that

many of the significant sentiments about and important reactions to United States financial accounting are revealed in these sources, nevertheless, an exhaustive and inclusive coverage is not attempted. For those more interested in the historical detail of the financial accounting of the United States Steel Corporation, the writer has placed various tables in an appendix for Chapters II, III, IV, V, VI, and VIII, which are included in individual appendixes which are included in the Appendix. The writer does examine in some detail, however, the financial accounting occurrences of the United States Steel Corporation in Chapters II, III, and IV so that the readers can better determine the behavior of management of these periods.

Methodology

A review was made of each of the annual reports of the United States Steel Corporation from 1902 to 1969. This review was the basis for noting the financial accounting of the United States Steel Corporation in 1902 and subsequent changes in its financial accounting. Access to the stockholders' minutes of the United States Steel Corporation's annual meetings enabled the writer to gauge the financial accounting influences brought to bear on management by stockholders. A court action brought by a group of stockholders in 1902 was examined. Various publications dealing with the general influence of stockholders were examined in order to obtain information on the general interest of stockholders in their corporations. Access to public statements by the management of the United States Steel Corporation aided the writer in the determination of the extent to which the United States Steel Corporation's financial accounting was affected by the aforementioned institutional forces. Personal conferences with the United States Steel Corporation officials were helpful in obtaining the location of various source material.

Financial accounting and related literature was searched for indications of accounting institutional influences. The two principal libraries utilized were the American Institute of Certified Public Accountants' library in New York City and the library at the University of Florida. The Accounting Research Bulletins, the Accounting Principles Board decisions, and the American Accounting Association statements were utilized in determining the effect of the American Institute of Certified Public Accountants and the American Accounting Association on financial accounting.

The files and reports of the United States Bureau of Corporations concerning its 1910 investigation of the United States Steel Corporation were reviewed at the National Archives in Washington, D. C., in order to obtain original source data on the formation and early years of the United States Steel Corporation and its financial reporting. The annual reports of the Commissioner of Corporations, issued as a part of the Annual Report of the Secretary of Commerce, were examined. These documents yielded data as to the extent of federal government interest in financial accounting from the turn of the century to 1913. An examination of the annual reports of the Federal Trade Commission was utilized to

ascertain governmental interest in financial accounting from the years 1914 to 1934.

The annual reports of the Securities and Exchange Commission, its Accounting Series Releases, and its other publications offered clues as to governmental interest from 1935 to the present. A conference with an official of the Securities and Exchange Commission[11] in Washington, D. C., provided additional background data. Certain congressional documents were examined to ascertain congressional interest in financial accounting. The libraries of the United States Treasury Department and of the Internal Revenue Service were utilized to determine the effect these agencies have had on financial accounting.

A conference was held with an official[12] of the New York Stock Exchange to obtain information on source documents pertaining to the financial accounting requirements of the Exchange during this period. A copy of a study of these requirements from 1895 to 1938 was examined by the writer. Correspondence was conducted with

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[11]Mr. Elmer C. Koch, Assistant to the Director of Accounting of the Securities and Exchange Commission, was interviewed in August of 1969.

[12]Mr. William J. Satterfield, Assistant Director of the Department of Stock List, was interviewed both in December of 1968 and August of 1969.

this official concerning the financial accounting aspects of the years after 1938.

Correspondence was conducted with the research director of the United Steelworkers Union to determine its influences upon the financial accounting of the United States Steel Corporation. An interview with one of the research assistants[13] of the United Steelworkers Union and a review of certain internal and external documents yielded data which could only have been obtained at the source.

Interviews to determine a brief history of each of the organizations and the extent of past interests in financial accounting were conducted with officials of the Federation of Financial Analysts, the Financial Executive Institute, the Robert Morris Associates, and the United Shareowners of America. Relevant economic history works were searched in order that a brief historical background for the institutional influences could be presented.

The work is basically organized around six major time periods. The first time period dealt with the founding of the United States Steel Corporation and its

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[13] Mr. Marco Vestich, Assistant to the Research Director of the United States Steelworkers, was interviewed in June of 1969.

first full-year annual report. As this 1902 report marked the inception of financial accounting of the United States Steel Corporation, it was thought necessary to study the financial accounting occurrences found in the report in some detail. The second span covered the years from 1903 to 1915 and discussed the laissez-faire years and the imposition of corporate income taxation. This period was chosen because of the desire to segregate financial accounting occurrences of peacetime from wartime. The third period ran from 1916 to 1929. It included the topics of World War I and the return to normalcy. This period allowed a segregation of financial accounting events of the World War I period and of the relatively prosperous period before the depression. The period of the depression from 1930 to 1940 was treated in the fourth time period. The depression caused a political and social upheaval in the United States and its effects on the financial accounting of the United States Steel Corporation were extremely important. The fifth section dealt with the period from 1941 to 1949 and was primarily concerned with World War II and its aftermath. World War II dominated the United States for this decade and financial accounting reflected this domination. The last section dealt with the current years from 1950 to 1969.

A very brief historical sketch is presented in each chapter; then a synopsis is made of the financial accounting events discussed in the chapter. These two sections compose the introductory part of each chapter. The body of each chapter is concerned with a discussion of the financial accounting events of United States Steel for the given period. A summary assessment section is included at the end of each chapter. In this section the writer makes certain judgments about the development of financial accounting in the United States for the period of time covered by the chapter, utilizing the annual reports of the United States Steel Corporation as reference points. The writer makes some overall assessments, based on the study, about United States financial accounting from 1902 to 1969 in the concluding chapter.

The annual reports of the United States Steel Corporation are not footnoted in the text. The reference to a year indicates the year for which the annual report was issued. Table II in the Appendix for Chapter VIII details the references to the annual reports by year and page.

CHAPTER II

THE FIRST FULL-YEAR ANNUAL REPORT OF THE UNITED STATES STEEL CORPORATION, 1902

Historical Résumé and Synopsis of Financial Accounting Events

The United States Steel Corporation was founded during the trust movement of 1898 to 1901,[1] and was labelled the first "Billion Dollar Trust."[2] A trust was a single corporation which held the securities of other companies as its only asset. The other companies kept

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[1] Edward Sherwood Meade, Trust Finance: A Study of the Genesis, Organization, and Management of Industrial Combinations (New York: D. Appleton and Company, 1903), p. 2.

[2] Arundel Cotter, United States Steel: A Corporation with a Soul (Garden City, New York, and Toronto: Doubleday, Page Company, 1921), pp. 22-4.

their corporate entities but their affairs were placed under the control of the permanent directors of the trust. Competition among these companies was thereby prevented.[3]

The promoter and the investment banker were the key men in the trust formation. The promoter first conceived the possibility of the enterprise; he then planned the details of the operation. He and the investment banker prepared the financial plan and then an underwriting syndicate was formed by the investment banker. The final step was the sale of the securities to the public.[4] Eight steel companies were acquired on April 1, 1901, by the United States Steel Corporation and four other companies were acquired during 1901. These companies produced at least 58 per cent of the steel making pig iron in the United States.[5]

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[3] Meade, Trust Finance, p. 37.

[4] Arthur Stone Dewing, The Financial Policy of Corporations (3rd ed.; New York: Ronald Press Company, 1926), p. 236.

[5] U. S., Bureau of Corporations, Report of the Commissioner of Corporations on the Steel Industry: Part I, Organization, Investment, Profits, and Position of the United States Steel Corporation, Herbert Knox Smith, Commissioner (Washington, D. C.: Government Printing Office, 1911), p. 12.

Topics discussed in this chapter include the inclusion of an Income Account in the annual report, the confusion between "funds" and "reserves," and the yearly recognition of depreciation. Other topics mentioned are the valuation issue, the overall reporting policy of the United States Steel Corporation, and the accounting treatment for inventories and working capital contributions.

Financial Accounting Events

The Income Account

The first two pages of the 1902 Annual Report were devoted to the yearly Income Account, which included the total net earnings from the General Profit and Loss Account, various appropriations, and the payments of interest and dividends.[6] (The Income Account appears as Table 1 in the Appendix for this chapter, and the General Profit and Loss Account in Table 2.) The placing of the Income Account at the beginning of the annual report was not surprising in

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[6]Refer to page 18 of the text for the statement that the annual reports of the United States Steel Corporation are not footnoted in the text but are referenced in Table II in the Appendix for Chapter VIII.

view of the importance of earnings for financial writers. Two editorials from the Wall Street Journal highlighted this importance.

The highest classification of a trust was the ranking of an investment security. An August 15, 1900, editorial in the Wall Street Journal listed thirteen questions that should be asked in the process of determining the investment status of a trust stock. The first six of these questions related to the earning power of the trust.[7] Without an income account and a detailed profit and loss account, such questions as how much were expenses reduced because of the consolidation, how much were gross earnings increased because of the consolidation, and what were the excess earnings over 7 per cent because of the consolidation could not be answered.

The renowned first editor of the Wall Street Journal, Charles H. Dow, wrote that values followed earnings and that while manipulation made temporary movements, the main course of prices was simply a response to changes in values. Prices could not be kept down if supporting

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[7]Meade, Trust Finance, pp. 123-4, quoting an editorial of August 15, 1900, from the Wall Street Journal.

values were present.[8] With no income account, earnings--the base of stock value--would have been hidden. It appeared that the income figure was a vital one for the editor of the Wall Street Journal.

Three other examples of interest in the Income Account were the interest shown by a financial service, the New York Stock Exchange, and the United States Industrial Committee. Of the first thirty industrial stocks analyzed in Poor's Manual 1903, twenty of them included a current net income figure.[9] This financial service undoubtedly served as an example of information that other companies reported and, as such, probably gave readers a standard to judge the amount of information disclosed by the various firms. In 1900, a committee of the New York Stock Exchange was formed to obtain compliance of the listed companies in the matter of the requirement of a detailed income statement published at least once a year. If a corporation desired to join the list after 1900, a

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[8] George W. Bishop, Jr., Charles H. Dow and the Dow Theory (New York: Appleton-Century-Crofts, Inc., 1960), p. 123, quoting an editorial of March 6, 1902, from the Wall Street Journal.

[9] Poor's Railroad Manual Co., Poor's Manual 1903 (New York: American Bank Note Company, 1903), pp. 1138-59.

published income statement was a prerequisite.[10] The United States Industrial Commission, a body comprised of five senators, five members of the House, and nine industrial representatives and founded by Congress on June 18, 1898, urged on March 1, 1900, that a profit and loss statement be published annually.[11] Thus, Congressional interest in financial accounting was present at the turn of the 20th century.

Financial accountants were also quite concerned about the income figure. Arthur Lowes Dickinson, the first senior partner of Price, Waterhouse & Company in the United States, stressed the fact that dividends could only be

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[10]Committee on Stock List of the New York Stock Exchange, "Historical Account of Relationship of New York Stock Exchange with Listed Companies as it affects Accountants," (review prepared for internal uses, April 8, 1938), p. 1.

Mr. William R. Satterfield, Assistant Director of the Department of Stock List of the New York Stock Exchange, was unable to locate the 1901 agreement of the New York Stock Exchange with United States Steel, but he felt that no listing contract after 1900 would have been drawn without reference to an annual publication of the income statement.

[11]U. S., Congress, House, U. S. Industrial Commission, Preliminary Report on Trusts and Industrial Combinations, H. R. Rept. No. 476, Part I, 56th Cong., 1st sess., 1900, pp. 1-7.

legally paid from profits.[12] Even in the purchase of a bond, the vital factor was held to be the stability of income.[13] The amount of net earnings represented the ideal basis for appraising the worth of the company. It was of great importance to determine the concept of net earnings.[14]

It was fairly evident that the net income figure was a very important financial accounting determination at the turn of the 20th century. <u>Poor's Manual</u> contributed to the climate of reporting a net income figure and the editor of the <u>Wall Street Journal</u> stressed the importance of earnings. The United States Industrial Commission stressed the annual reporting of a profit and loss statement. The New York Stock Exchange required the publishing of an annual income statement for companies joining the list after 1900. Leading accounting practitioners and writers

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[12] Arthur Lowes Dickinson, "The Profits of a Corporation," <u>Official Record: Congress of Accountants, 1904</u> (New York: George Wilkinson, 1904), p. 173.

[13] George E. Barret, "How to Investigate Securities," <u>The Journal of Accountancy</u>, 4 (May, 1907), 24.

[14] Herbert Joseph Davenport, "Some Problems in Corporation Accounting," <u>The Journal of Accountancy</u>, 4 (October, 1907), 451.

stressed the importance of the net income figure. The importance placed on the income figure and on its computation tend to give less credence to the oft-expressed view that financial accounting was more balance-sheet oriented than income-statement oriented until the 1930's. (Refer to pages 6-7.)

The Use of Funds

Four funds were established from the Income Account. They were entitled: (1) the Sinking Funds on Bonds of Subsidiary Companies; (2) Depreciation and Extinguishment Funds (regular provision for the year); (3) Extraordinary Replacement Funds (regular provisions for the year); and (4) Special Fund for Depreciation and Improvements. Two other funds were established by charges to the General Profit and Loss Account. These were: (1) the Contingent and Miscellaneous Operating Funds; and (2) the Insurance Fund. These six funds were portrayed in the Balance Sheet under the caption Sinking Reserve Funds in the liability section.

Sinking and Reserve Funds:

Sinking Fund on U. S. Steel Corporation Bonds	$ 1,773,333.33
Sinking Funds on Bonds of Subsidiary Companies	217,344.36
Depreciation and Extinguishment Funds	1,707,610.59
Improvement and Replacement Funds	16,566,190.90
Contingent and Miscellaneous Operating Funds	3,413,783.50
Insurance Fund	1,539,485.25
	$25,217,747.93

An accounting writer felt that care should have been exercised to avoid confusing the reserve accounts with an actual sum of money and/or working capital set aside for a particular purpose--that is, a fund. The term "reserve" was to be used for "an amount set aside out of profits either for some specific purpose or for the general purpose of strengthening the business by way of accumulating working capital."[15] If there were no specific allocation of cash and/or other working capital accounts set aside, the use of the term "fund" was not advisable.[16]

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[15] Leo Greendlinger, Accounting Practice, Modern Business Series, Vol. V (New York: Alexander Hamilton Institute, 1910), p. 239.

[16] Ibid.

The United States Steel Corporation had no specific category in the asset side of its Balance Sheet for a fund of cash and/or other working capital accounts for these fund balances. However, the 1902 Annual Report did contain a caption in the schedule of funds that mentioned a relationship between "funds" and "reserves."

> The balance to the credit of several funds on December 31, 1902, per the preceding table, are included in the current assets of the organization,
>
> | | |
> |---|---|
> | In General Cash | $ 1,773,333.33 |
> | In Current Assets: | |
> | Cash, Marketable Securities, Inventories | 18,491,145.85 |
> | | $20,264,479.18 |

Whether this entire amount was actually set aside for the specific funds was problematic.

The United States Steel Corporation's handling of these terms probably left the reader unclear as to whether there was an actual allocation of cash for the "funds." This was important because it was apparent from the dollar amount of these "funds" that they were a significant part of the United States Steel Corporation's financial accounting presentation. Two of these "funds" are now discussed in more detail.

Bond Sinking Fund

The importance of the public accounting firm of Price, Waterhouse & Company, which has been the public accounting firm auditing the financial statements of the United States Steel Corporation from 1902 to 1969, in the matter of the United States Steel Corporation financial accounting policy is illustrated by this particular topic --Bond Sinking Fund. Controversy surrounded the inclusion of the bond sinking fund amount as a deduction from net earnings. Should conservatism[17] rule or should actuality prevail? The view that conservatism was more important in this matter than legal actuality was held by Arthur Lowes Dickinson and Leo Greendlinger. Dickinson agreed that the charge to earnings for the bond sinking fund amount was not an expense but the reduction of the liability. However, since the only source of the redemption of bonds was income and since it was usual to provide in the bond contract that the sinking fund came from yearly profits, Dickinson felt that the charge for the reserve fund should

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[17]Conservatism, as here employed, referred to the reporting of a lower net income figure because of the decision to employ a financial accounting procedure which was not related to an actual financial accounting event. Other uses of this term are found in Chapter III and in other parts of the study.

be to the income account.[18] Greendlinger felt that since this charge to the income account prevented directors from declaring excess dividends, this practice was desirable. He stated:

> Then too, since accountants are not living in a scientific world of their own construction, wherein everything is arranged to their own ideas, but in a commercial world which as yet knows very little about accounting principles, the shrewd accountant will make concessions, and base his practice upon business and legal principles as they now are, not as, in theory they should be.[19]

Seymour Walton attacked this view which he held failed to distinguish between a fund and a reserve account. Should one charge the part payment of a six-month note to revenue? Why then should one do it with a bond which runs forty times longer than the six-months note? The stockholders were misled as to the amount of surplus available for dividends. Since the amount of the retired bonds was charged to the liability account, the amount of the bond sinking fund reserve was constantly increasing.

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[18] Greendlinger, Accounting Practice, p. 366, quoting Arthur Lowes Dickinson.

[19] *Ibid.*, p. 367.

This account in reality represented a locking up of the surplus amount and should have been classified as such.[20]

The strength of the influence of the American branch of Price, Waterhouse & Company in its relations with the United States Steel Corporation management was undoubtedly apparent here, as the United States Steel Corporation reflected its public accounting firm's view on the deduction of the bond sinking fund from net earnings. This policy probably dampened stockholder confidence, since a lower earnings figure was reported.

Depreciation Funds

In 1902, the first of the three fund accounts applicable to capital assets was the Depreciation and Extinguishment Fund. It was charged for the amount needed to liquidate the original capital investment in the properties at the end of their useful life. The second was the Extraordinary Replacement Fund, which was charged for the amount estimated to have been needed to improve and modernize the fixed assets. The third was entitled

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[20] Seymour Walton, "Sinking Funds and Reserve Accounts," The Journal of Accountancy, 6 (October, 1908), 394-9.

the Special Fund for Depreciation and Improvements. The topic of depreciation centered around (1) whether it should be recognized, (2) what basis should be employed to calculate depreciation, (3) to what extent it should be used to stabilize earnings, and (4) where on the balance sheet should the accumulated credits be shown. The following discussion of the views of leading accounting authorities on the matter of depreciation showed that this financial accounting topic was well studied at this time. These views should prove to be useful for the other occasions when the topic of depreciation will be discussed in this work.

Ewing Matheson in his classic work, The Depreciation of Factories, stressed that the determination of the proper amount of depreciation should be a function of those who were technically acquainted with fixed assets.[21] Because of the problems associated with a yearly revaluation of fixed assets, it was most desirable to establish an average rate to be written off each year. This amount would be reviewed by a complete or partial

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[21] Ewing Matheson, The Depreciation of Factories (2nd ed.; London: E. & F. N. Spon; New York: Spon & Chamberlain, 1893), preface.

valuation at given intervals.[22] The three factors to be considered in the depreciation process were held to be the original value or cost, the probable working life, and the salvage value. Specific reference was made to the practice of varying depreciation amounts with good years.

> . . .In the large industries such as iron, steel, and chemical works, the improved methods that are continually arising render necessary an outlay of a speculative nature for new experiments and plant which if successful will render much of the old plant obsolete of diminished value. A large annual return may alone justify the outlay, and such return cannot safely be treated as profit without a considerable reduction in capital value. Therefore, while in average or normal years of working a moderate rate of depreciation may suffice for mere physical deterioration, advantage should be taken of prosperous years to write down liberally the book value of the plant.[23]

Matheson stated that when the write-down was to a fund entitled Depreciation and Reserves and charged to the income statement, shareholders might be led to the belief that there was an actual sum of money set aside to replace the capital assets. This association between the accounts

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[22] *Ibid.*, p. 15.

[23] *Ibid.*, p. 44.

and funds was not advisable.[24] Matheson urged the recognition of an amount of depreciation established by technically oriented experts, the cost basis for depreciation, the use of a larger depreciation amount in years of prosperity, and the careful distinction between cash and depreciation.

Garcke and Fells stressed the factor of obsolescence. This factor necessitated a depreciation amount even though the fixed assets were renewed continually by repairs and maintenance. Depreciation was a judgmental matter which should be taken into account each year. They held that the ideal method of computing depreciation was to apportion the original cost plus interest and renovations less the residual value over the estimated useful life of the fixed asset.[25] Garcke and Fells also urged the yearly recognition of depreciation and the cost basis as the starting point of depreciation.

Francis W. Pixley held for a strict adherence to the cost basis for recording fixed assets and depreciation.

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[24] Ibid., p. 21.

[25] Emile Garcke and J. M. Fells, Factory Accounts (5th ed.; London: Crosby, Lockwood and Son, 1902), pp. 105-17.

The reserve account was to be subtracted from the cost of the fixed assets to give a fair value of fixed assets for the going concern. He advocated that the accountant should determine the cost of the fixed asset and that engineers in the operating departments should determine the amount of depreciation.[26] Pixley held views similar to that of Matheson on the cost basis for depreciation, the nature of the reserve account, and the use of engineers to estimate amount of depreciation.

"Prudential depreciation" was to be established as a charge against revenue before any dividend could be declared. The purpose was to provide against unrealized but probable losses in capital assets. The board of directors bore a considerable responsibility in including such a charge, in addition to the "working depreciation" charge which related to the replacement of the realized losses in fixed assets. This policy was to be followed even though it might result in shareholder displeasure. The board of directors were to remember that they had a very strong trustee relationship with present and future

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[26]Francis W. Pixley, <u>Accountancy</u> (London: Pitman and Sons, Ltd., 1908), pp. 209-12.

shareholders and it was the duty of the board of directors to replace the fixed assets.[27] This writer stressed the importance of the board of directors' allowing an amount for possible losses in the value of fixed assets.

Seymour Walton felt that depreciation was the lessening of value of fixed assets due to use and contrasted it to fluctuations in value by outside influences and not use. Since fixed assets were not ordinarily held for resale, accountants should ignore the change in value due to fluctuations. It was the auditor's duty to be sure that an expression of depreciation appeared in the accounts and the writing-off of an arbitrary amount to equalize earnings should be unreservedly condemned by the auditor.[28] Walton was in favor of the yearly recognition of depreciation and was opposed to its use for the equalization of income.

It appeared that the United States Steel Corporation's decision to recognize depreciation on a yearly basis was in line with the insistences of accounting

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[27] John H. Armstrong, "Depreciation Reserves," The Accountant, 29 [New Series] (August 8, 1903), 1014-18.

[28] Seymour Walton, Auditing, Modern Business Series, Vol. XI (New York: Alexander Hamilton Institute, 1911), pp. 63-7.

writers. The basis for the calculation of depreciation by the United States Steel Corporation and the extent to which it was used to stabilize earnings could not be determined from the 1902 Annual Report. The United States Steel Corporation classified the depreciation reserves as a part of the liability section of the Balance Sheet and not, as recommended by accounting writers, as a deduction from the fixed asset account.

It was apparent that the topic of depreciation was a financial accounting item that was covered extensively in the literature of the time. The cost basis for depreciation appeared to have been accepted. The stress placed on the utilization of engineers to estimate the yearly amount of depreciation was interesting in the light of today's employment of depreciation as a result of a mathematical formula not necessarily coinciding with engineering estimations.

Valuation of The United States Steel Corporation

It was stated in the 1902 Annual Report that:

> The Balance Sheet included in this report, page 24, exhibits the combined assets and liabilities of the United States Steel Corporation and of the Subsidiary Companies, based on the valuation at which the stocks and bonds

> of the Subsidiary Companies were taken over by the Steel Corporation, liabilities from one company to another company being omitted.

This paragraph in the report was only one sentence but it contained the most controversial accounting and financial issue of all--that is, the matter of the valuation of the corporation. The United States Steel Corporation employed the par value of its securities, which were comprised of bonds, preferred stock and common stock, exchanged for the securities of its subsidiary companies as the basis for the valuation of its assets. The use of the par value of these securities as the capitalization basis was held by a financial writer to be generally agreed upon.[29] The impotence of the auditor in this valuation process was accepted by such accounting authorities as Henry Rand Hatfield, Arthur Lowes Dickinson, and Walter A. Staub.

Hatfield felt that it was customary to record as the cost of property the par value of the stock exchanged

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[29]Meade, Trust Finance, p. 290.

for it.[30] The reason for this accounting practice was that there was no satisfactory criterion for the valuation if manufacturing establishments combined into a trust. Even the cost to the combining companies could not be relied upon because the assets may have been acquired at an exorbitant price or they may have been purchased at a bargain sale. For this reason, the courts have relied upon the valuation of the company's directors.

> An illustration of the extent to which this deference to the directors' discretion may go is found in a decision of one of the Federal courts to the effect that the purchase by a corporation for $2,000,000 bonds and $3,600,000 stock of a railroad bed, the construction of which cost $2,000 and for which the vendor had paid $15,000 was not on the face, a fraudulent transaction [Stewart v. St. Louis, etc., R.F. 41 Fed. Rep. 736 (1887)][31]

Hatfield felt that the solution was to value the assets at the par value of the stock but that this method of valuation should be clearly explained by a statement in

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[30] Henry Rand Hatfield, Modern Accounting: Its Principles and Some of its Problems (New York and London: D. Appleton and Company, 1910), p. 79.

[31] Ibid., pp. 161-2.

the balance sheet.[32] Dickinson stated that "If stocks or bonds are issued for the purchase of any definite property, it may be presumed that the property is worth the par value thereof."[33] Staub felt that there was a consensus that the auditor could not expect to be an appraiser and, therefore, determine the actual value of the concern.[34]

In 1900 the United States Industrial Commission concluded that overcapitalization as a result of promoters' and underwriters' urge for huge profits was often against the public interest and should be checked. Even a fairly conservative combination resulted in capitalization that was two to three times the value of the plants and patents.[35]

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[32] Ibid., pp. 170-1.

[33] Dickinson, "The Profits of a Corporation," 185.

[34] Walter A. Staub, "Mode of Conducting an Audit," Official Record: Congress of Accountants, 1904 (New York: George Wilkinson, 1904), p. 210.

[35] U. S., Industrial Commission, Preliminary Report on Trusts and Industrial Combinations, pp. 12-6.

There was very little that accounting practitioners and writers could do about the valuation of the United States Steel Corporation. The Industrial Commission could study cases of overcapitalization and recommend a checking of the power of promoters and underwriters in this area but it did no more. A financial writer, Meade, was willing to accept the fact that the securities were selling at their face value as the criteria for over-capitalization.[36] This judgment was, of course, after the fact of the financial accounting valuation. This very important matter of valuation was left to the board of directors and the management of the United States Steel Corporation. Was the stock of the United States Steel Corporation watered? If so, how much water was estimated to be present? Was the valuation amount of the board of directors and management questioned in the courts?

Stock watering was defined as the issuance of nominally fully-paid stock in an amount exceeding the value of the assets against which the stock has been issued. Three advantages accrued to the corporation from this practice. First, the public tended to overvalue the

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[36] Meade, Trust Finance, p. 303.

securities on the market; second, the creditors or future creditors of the company were given an exaggerated equity position on which to base their credit decision; third, the excess profit position of the combination was concealed from the public and from competitors by the high capitalization.[37]

The relativeness of the valuation process was illustrated by the varying values of the United States Steel Corporation obtained by different experts. Charles M. Schwab, the United States Steel Corporation's first president, estimated the value of the corporation at $1,466,278,000 in the year 1902 in an affidavit in regards to a court controversy about the conversion of preferred stock into bonds. The valuation principles and breakdown were illustrated by the following summary of the affidavit in Table 3 of the Appendix for this chapter. The decision of the court was to uphold the value of the United States Steel Corporation as reported on the certificate value. This certificate was held to be filed in honesty and good faith and anyone questioning such valuation must bear the

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[37]David L. Dodd, Stock Watering (New York: Columbia University Press, 1930), pp. 3-12.

burden of proof. The dissident stockholders could not even meet the minimum requirements for proving their point as to the overvaluation of the United States Steel Corporation.[38]

William H. Lough estimated that a minimum of $542,000,000 of the capitalization of the United States Steel Corporation represented water. The basis for this amount was the $1,252,000,000 of securities--$868,000,000 of stock issued to the owners of the combining companies, $240,000,000 of stock issued to the promoters, and $144,000,000 of additional bonds issued to the owners of the combining companies--added by the combination and the $710,000,000 of aggregate capitalization of the old companies. However, the $710,000,000 figure was already watered before the combination occurred.

> But what are the facts as to the capitalization of the original companies? Daniel G. Reid, president of the American Tin Plate Company, testified before the Industrial Commission that of the $46,000,000 capitalization of the company, $18,000,000 (preferred stock) was supposed to represent the value of the property and $28,000,000 (common stock) represented hopes for the future and pay of the

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[38] Edward Sherwood Meade, "The United States Steel Corporation's Bond Conversion," Quarterly Journal of Economics, 18 (November, 1903), 47-8.

> promoter. It is well known that in the capitalization of the National Steel, American Can Steel, and American Sheet Steel Companies, all of which were promoted by the same interests as the American Tin Plate Company, the same principle was followed.[39]

Three different estimates of the value of the United States Steel Corporation at April 1, 1901, were made in the Bureau of Corporation's study of the founding of the United States Steel Corporation. The first method was the cost of the tangible property to the combining companies and yielded an estimate of $676,000,000 as the valuation. The second method was the addition of the market values of the securities of the combining companies and yielded an estimate of $793,500,000 as the valuation. The third method was the detailed estimate of the physical prcperties of the departments of the firm. This method was held to be the most detailed and conclusive of the three. The valuation and breakdown under this method appeared thusly:

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[39] William H. Lough, Corporation Finance, Modern Business Series, Vol. VI (New York: Alexander Hamilton Institute, 1913), p. 81.

Manufacturing properties, including blast furnaces	$250,000,000.
Transportation properties	91,500.000.
Coal and Coke properties	80,000,000.
Natural gas and limestone properties	24,000,000.
Current assets	136,500,000.
Ore properties	100,000,000.
	$682,000,000.[40]

The estimated amount of water and intangibles as of April 1, 1901, under the third method was $721,328,839.[41]

While there was water present in the United States Steel Corporation at its inception, the writer was very hesitant about issuing a blanket condemnation of the United States Steel Corporation's board of directors and management. One reason was that if one accepted the United States Bureau of Corporation's amount of $721,300,000 as water and intangibles (there was no attempt to factor out these intangibles), the overcapitalization was only a little more than 100 per cent over the value of the assets. The United States Industrial Commission held

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[40] United States Bureau of Corporations, Report of the Commissioner of Corporations on the Steel Industry: Part I, letter of submittal, xx-xxi.

[41] Ibid., p. 328.

that a fairly conservative capitalization was one that was capitalized at two to three times the actual value of its plants and patents. (Refer to page 40.) The United States Steel Corporation's overvaluation was far less than this. If one held, like Meade, that the capitalization of a new company should be based on a conservative estimate of its earning power,[42] there might have been no water. The writer is of the opinion that the board of directors and the management of the United States Steel Corporation did not misuse their prerogatives as to valuation. Even if one were to judge the board of directors and management harshly in this matter, one would have to temper his statement with the fact that the United States Steel Corporation underwent a de-watering policy for the next three decades.

Reporting Policy

The strong influence of Price, Waterhouse & Company in the reporting of the United States Steel Corporation is noted in the subsequent discussion. The British public accounting firm of Price, Waterhouse & Company, through its

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[42] Meade, *Trust Finance*, p. 292.

American branch, Jones and Ceasar, had dealt with J. P. Morgan enterprises before the formation of the United States Steel Corporation. In December, 1897, Jones and Ceasar prepared an examination of the records of the companies which combined into the American Steel and Wire Company of New Jersey, which was later one of the companies combined to form the United States Steel Corporation. It was on this engagement that the firm acquired experience in the difficult technical problem of reconciling the individual company's fixed asset account to the larger excess of appraisal values.[43] Jones and Ceasar performed the accounting assignments for the combination which formed the United States Steel Corporation, but the stockholders voted on February 17, 1902, to have the British parent of Jones and Ceasar perform the yearly audit. Thus the United States Steel Corporation became the first major United States' industrial company to adopt the British practice of the stockholders' selecting the auditors.[44]

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[43] Chester Whitney DeMond, _Price, Waterhouse & Company in America: A History of a Public Accounting Firm_ (New York: Comet Press Inc., 1951), pp. 53-4.

[44] _Ibid._, p. 59.

While it was the stockholders who voted for Price, Waterhouse & Company as auditors, the fact was that not more than twenty people, many of them reporters, were present at the annual meeting in 1902.[45] It appeared that management really picked Price, Waterhouse & Company through the proxy method.

Two major accounting decisions appeared to have been made by the public accounting firm. One was the aforementioned issue of the appropriation of an amount equal to the bond sinking fund from net earnings. Arthur Lowes Dickinson was a staunch proponent of this practice. (Refer to pages 29-31) The other was the matter of the issuance of consolidated statements. The United States Steel Corporation's lawyers and bankers desired stockholder statements covering just the activities of the parent. Thus the only subsidiary operations that would have appeared were the dividends and interest they paid to the parent company. Dickinson held out for consolidated statements of operations so that shareholders could acquire a more accurate presentation of their company.[46]

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[45]"The Steel Trust Meeting," The New York Times, February 18, 1902, p. 14.

[46]DeMond, Price, Waterhouse & Company in America, p. 60.

The management of the United States Steel Corporation was very committed to an annual reporting policy. An illustration of this policy toward reporting was the exchange between Judge Gary, the first chairman of the Executive Committee of The United States Steel Corporation, and another member of the board of directors after the public issuance of the 1901 Annual Report.

> "Judge Gary," he (Henry Rogers of the Standard Oil Company) said, "do you mean that you are going to give out that report to the newspapers?"
>
> "I do," he replied.
>
> "Now, Judge, I am an older man than you, I have been longer in business. Some day you will have a poor report, what will you do then?"
>
> "Give it out, Mr. Rogers, give it out."[47]

Judge Gary and William J. Filbert, the first controller of the United States Steel Corporation, were ranked as true pioneers in the field of corporate reporting. Gary utilized the publicly issued statements as an important

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[47] Ida M. Tarbell, The Life of Elbert G. Gary: A Story of Steel (New York and London: D. Appleton and Company, 1925), p. 142.

factor in the United States Steel Corporation's public relations program.[48]

As early as January 23, 1895, the New York Stock Exchange had recommended to listed companies that they publish and distribute to stockholders, at least fifteen days before the annual meeting, a balance sheet and an income account. By 1900, as already mentioned, an effort to obtain compliance took the place of the recommendation.[49] The United States Industrial Commission recommended that corporations be required to report to its stockholders its financial condition, verified by a competent auditor, at least once a year. Trusts should be required to publish an audited annual report, including both a reasonably detailed balance sheet and profit and loss report. Such reports would be open to governmental inspection.[50]

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[48] DeMond, Price, Waterhouse & Company in America, p. 59.

[49] Committee on Stock Lists of the New York Stock Exchange, "Historical Account of Relationship of New York Stock Exchange with Listed Companies as it affects Accountants," p. 1.

[50] United States, Industrial Commission, Preliminary Report on Trusts and Industrial Combinations, p. 6.

The influence of Price, Waterhouse & Company was felt heavily in the overall reporting policy of the United States Steel Corporation. The issuance of consolidated statements led to a far better informed reader of the annual report than the very sketchy unconsolidated approach desired by the United States Steel Corporation's lawyers. Both the New York Stock Exchange and the United States Industrial Commission stressed annual reports. As was already mentioned, financial services, such as Poor's Manual, published yearly summaries of companies. (Refer to page 23.) There certainly was no vacuum of institutional interest in the financial accounting reporting. The management of the United States Steel Corporation not only expressed a very open reporting policy but also put such expression into practice.

Other Accounting Matters

Accounting writers stressed the importance of the realization of profit on the date of sale and, therefore, accepted the doctrine of not carrying inventory amounts at more than cost.[51] This rule of revenue realization

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[51]Walton, Auditing, p. 56.

apparently was followed by the United States Steel Corporation, because the statement was made in the 1902 Annual Report that "Inventories are taken on basis of actual cost of the materials and products at the several departments of the companies holding the same."

The Undivided Surplus Account had the two separate classifications of Capital Surplus Provided in Organization of the United States Steel Corporation of $25,000,000.00 and of Surplus Accumulated by all Companies since Organization of the United States Steel Corporation of $52,874,597.05. Controversy surrounded the inclusion of the $25,000,000 of working capital received from the promoters as part of the Undivided Surplus of the company. Dickinson stated that the Undivided Surplus Account had the connotation of profits and surely that was not the case for working capital contributed by the promoters.[52] There was a detailed schedule of the Undivided Surplus Account. There was a decrease of $1,583,514.70 in the Undivided Surplus Account for amounts Written off in 1902 to Cost of Property and for Adjustments of Sundry Contracts and

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[52] Arthur Lowes Dickinson, "Notes on Some Problems Relating to the Accounts of Holding Companies," <u>The Journal of Accountancy</u>, 1 (April, 1906), 487.

Accounts. The warning about the use of the Undivided Surplus Account to absorb and hide items that might be pertinent in the judgment of the earnings capacity of the business was made by Dickinson.[53] The sum charged off to surplus in 1902 was minor. However, the succeeding years will illustrate very poignantly the problem of extraordinary charges and credits to the Undivided Surplus Account, in the light of Dickinson's warning.

Accounting writers' inventory valuation method was followed by the United States Steel Corporation. The opinion of Price, Waterhouse & Company's senior partner in America was not followed on the issue of the working capital contribution.

Other Features of the Annual Report

A schedule entitled Maintenance, Renewals and Extraordinary Replacements classified these expenditures by type of property. The amount of quarterly dividends since the first quarter of operations and the quarterly dividends' relation to net profit for the quarter and to

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[53] Dickinson, "The Profits of a Corporation," 189.

the surplus amount at the end of each quarter was illustrated in another section. A schedule of the activity of the trustees of the bond sinking fund was portrayed. Schedules of raw material production and of rolled and other finished products for sale gave the reader an inkling as to the happenings of the firm in terms of tons. A very detailed schedule was made of the changes in Bonded, Debenture, and Mortgage Debt. A list of the principal additions to the Property Account covered four pages. Detailed information was given about the Union-Sharon Purchase and of the Purchase of Troy Steel Products Company.

The average number of employees and their total salaries and wages were shown in a schedule entitled Employees and Pay Rolls. A description of the employees' stock purchase plan was given in a section entitled Employees' Subscriptions to Preferred Stock. A schedule was prepared of the number of stockholders. Orders on hand were stated. A discussion of top management policy regarding the handling of the subsidiary companies and a list of their presidents were included in the Organization section.

It appeared that a funds statement was included in the 1902 Annual Report. The Summary of Financial

Operations followed the General Profit and Loss Account. The make-up of the funds statement is worth noting and is Table 4 in the Appendix for this chapter. A description of the different bond issues, the amount of each issue, the amount held by the trustee of the sinking funds, the balance in the hands of the public, the maturity date of each issue, and the interest rate and interest payment dates of each issue were included in a schedule entitled Bonded and Debenture Outstanding, December 31, 1902. Monthly earnings from April 1, 1901, to December 31, 1902, were shown. Thirteen pages were devoted to a very lengthy listing of the various types of property held by the subsidiaries.

Management can only be commended for the very informative data it presented to the stockholders. The writer had envisaged that the 1902 Annual Report would have been comprised of a one-page balance sheet. When he reviewed the 1902 Annual Report, he found much detailed information not normally presented in annual reports.

Summary Assessment

The writer was surprised at the depth at which various financial accounting topics were examined at the turn of the 20th century. The writer concludes that the general opinion that financial accounting was more balance-sheet oriented than income-statement oriented until the 1930's should be re-examined in the light of the stress placed on the income figure in the early 1900's. This heritage of financial accounting should be mined for ideas which may be quite useful for present-day financial accounting.

For example, it is possible that a depreciation amount selected by means of an engineering study would yield a more meaningful depreciation amount, and hence a more meaningful income amount than some of today's depreciation methods. The use of the double-declining-balance method of depreciation in a year in which considerable fixed asset procurement occurred and relatively little production happened would undoubtedly yield an expense amount much greater than the engineering estimate of depreciation. Might not those interested in the net income figure be better served by a net income figure arrived at by utilizing the engineering estimate of

depreciation? Another example is the probable abuse by management of the corporate valuation procedure. Any financial accounting model based on valuation by management through an appraisal method should be viewed today in the light of past experience.

Various accounting forces played a very important role in financial accounting at the turn of the 20th century. Leading writers and practitioners stressed the importance of the income amount and provided guidance in the area of "funds" and "reserves." Controversy existed in the question of the deduction from net earnings of the bond sinking fund amount and the United States Steel Corporation's approach was in line with the approach suggested by the senior partner of Price, Waterhouse & Company in America. The topic of depreciation was well covered in the literature. Accounting practitioners and writers admitted their impotence in the very important area of corporate valuation. Price, Waterhouse & Company insisted upon a consolidated basis of reporting but was not successful in getting the United States Steel Corporation to reclassify its working capital surplus account. Accounting writers stressed the cost basis of inventory valuation.

There were other influences on financial accounting besides the accounting forces. The editor of the Wall

Street Journal stressed the importance of an income statement and Poor's Manual provided an example of what corporations were reporting. The New York Stock Exchange played a very important role in the requiring of the publication of an annual balance sheet and income statement for corporations joining the list after 1900. Congress through the United States Industrial Commission, recommended the annual reporting of audited statements. The United States Industrial Commission findings on overcapitalization might have had an effect on the valuation of the United States Steel Corporation, as the United States Steel Corporation was overcapitalized by a much smaller per cent than even fairly conservatively valued companies.

A few dissident stockholders failed in a court action to question the valuation of the United States Steel Corporation. While stockholders did vote for Price, Waterhouse & Company to be the auditors of the United States Steel Corporation, management really picked the auditors through the proxy method.

The management of the United States Steel Corporation adopted a very broad reporting policy. Management exercised its discretion in financial accounting on such issues as valuation, the method and placement of

funds and reserves for depreciation, the classification of the working capital contribution, and the use of the Surplus Account. Management may have created a feeling of overconfidence to stockholders because of the "very moderate" overcapitalization. The non-disclosure of the method of depreciation may have caused some uncertainty, but overall management's financial accounting activities were very well disclosed to stockholders.

CHAPTER III

THE LAISSEZ-FAIRE YEARS AND THE IMPOSITION OF THE FEDERAL CORPORATE INCOME TAX 1903-1915

Historical Résumé and Synopsis of Financial Accounting Events

These years could not be labeled as unbridled "laissez-faire" years. President Theodore Roosevelt shocked big business by his smashing of the Northern Securities consolidation. The Hepburn Act of 1906 gave the Inter-State Commerce Commission the power to determine and promulgate just and reasonable rates and to prescribe a uniform accounting system for railroads. Conservation policies projected the federal government into a new sphere of activity. The United States Bureau of Corporations was established in February, 1903, as a division in the Department of Commerce and Labor in order to investigate trusts and combinations and to advise the

Justice Department on antitrust matters. The muckrakers severely attacked the big business power structure.[1] The Bureau of Corporations urged that annual reports be issued.[2] Yet one could classify this era in financial accounting as an era of relative freedom. The editor of The Journal of Accountancy stressed that management had much leeway in the decision to report the results of stewardship and that the investors had not made significant demands for adequate reports.[3]

The Corporate Income Tax of 1909 was included as a section in the Revenue Act of 1909. While no specific system of bookkeeping or accounting was required by the Bureau of Internal Revenue, the accounting system of the firm was to be established in such a manner that the return

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[1] Harold V. Faulkner, The Decline of Laissez-Faire, The Economic History of the United States, Vol. VII (New York and Toronto: Rinehart & Co., Inc., 1951), p. 35, p. 205, pp. 377-78, pp. 177-9.

[2] U. S., Department of Commerce and Labor, Reports of the Department of Commerce and Labor, 1906 (Washington, D. C.: Government Printing Office, 1906), p. 16.

[3] "The Reports of American Corporations," The Journal of Accountancy, 2 (October, 1906), 458.

could be readily verified upon examination.[4] The importance of an accounting system was further magnified by Article 183 of the Bureau of Internal Revenue regulations for the 1913 Act.

> The books of a corporation are assumed to reflect the facts as to its earnings, income, etc. Hence they will be taken as the best guide in determining the net income upon which the tax imposed by this act is calculated. Except as the same may be modified by the provisions of the law wherein certain deductions are limited, the net income disclosed by the books and verified by the annual balance sheet, or the annual report to the stockholders should be the same as that returned for taxation.[5]

The financial accounting events discussed in this chapter include the leeway the management of the United States Steel Corporation had in utilizing the Undivided

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[4]U. S., Department of the Treasury, Office of the Commissioner of Internal Revenue, T. D. 1571, Regulations Relating to the Assessment and Collection of the Special Excise Tax Imposed by Section 38, Act of August 5, 1909, on Corporations, Joint Stock Companies, Associations, and Insurance Companies (Washington, D. C.: Treasury Department, December 3, 1909), p. 11.

[5]U. S., Department of the Treasury, Office of the Commissioner of Internal Revenue, Regulations No. 33, United States Internal Revenue Law and Regulations Relative to the Tax on Income of Individuals, Corporations, Joint Stock Companies, Associations, and Insurance Companies (Washington, D. C.: Government Printing Office, 1914), p. 84.

Surplus Account for miscellaneous expenses and reserves and in the applications of the many-faceted concept of conservatism. Other topics discussed are the issuance of a Comparative Income Account, the statement of the basis for depreciation by the United States Steel Corporation, the modification of its Condensed General Profit and Loss Account, and the regulations of the Bureau of Internal Revenue.

Financial Accounting Events

Utilization of the Undivided Surplus Account

Starting with the 1903 Annual Report, the United States Steel Corporation adopted the financial accounting policy of utilizing the Undivided Surplus Account for miscellaneous charges. The expense associated with the conversion of 7 per cent preferred stock for 5 per cent bonds amounted to $6,800,000 and was charged to the Undivided Surplus Account. In the 1903 and 1904 Annual Reports, charges were made to the Undivided Surplus Account for expenditures for construction and for payments of capital liabilities; $17,234,128.58 was charged off in 1903, and $8,493,235.58 in 1904. The amount of $2,500,000 was debited to the Undivided Surplus Account in 1906 to create a Reserve to Cover Possible Losses in Advanced Mining Royalties. There was an entry made from the

Undivided Surplus Account for $663,018.37 for a permanent pension fund reserve in 1911. The sum of $500,000.00 was charged to the Surplus Account each year from 1912 to 1916. In the Undivided Surplus Account of 1912, the charge of $913,950.00 was made for the discount on bonds issued by subsidiary companies. In 1914, this policy was reversed and $878,026.84 was added back to Undivided Surplus and debited to a deferred asset account on the Balance Sheet.

The United States Steel Corporation used the Undivided Surplus Account as a device to record charges such as the bond conversion expense, possible losses in advanced mining royalties, and the pension reserves which could have been made either to the General Profit and Loss Account or to the Income Account. Stockholders may have been led to overconfidence because of the resultant higher income figure, but the amounts of the charges for the possible losses in advanced mining royalties and for the pension reserve were not very large in comparison with the income figure. The charge to the Undivided Surplus Account for expenditures for property and for the payment of capital liabilities was probably another instance of conservatism, which is discussed in the next section. The reversal of the bond discount entry may have been in response to the fact that the general practice in

accounting was to amortize the discount over the life of the bonds.[6]

Conservatism

Conservatism was a word employed in the financial accounting parlance of the times for the purpose of (1) balance-sheet valuation, (2) recognition of revenue, (3) normalizing income, and (4) de-watering the original overcapitalization of a company. As the writer could not differentiate whether the United States Steel Corporation was more interested in normalizing income or in de-watering (or possibly a combination of both), he combined the third and fourth uses in this discussion.

The term "conservative" was employed in the annual reports of the United States Steel Corporation for the first time in the description of inventory valuation in the 1903 Annual Report. "Inventory valuations are conservative. They were taken on the basis of actual purchase or production cost of materials to the respective companies holding the same, unless (as happened in some

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[6]Robert H. Montgomery, ed., The American Business Manual: A Complete Guide to Modern Systems and Practise, Vol. III: Administration (New York: P. F. Collier & Son, 1911), p. 860.

circumstances) such cost was above the market value on December 31, 1903, in which case the market price was used." This policy led to a charge to the Income Account of $5,378,837.63 for Charged for Depreciation in Inventory Valuations and for the Adjustments of Sundry Accounts. The inventory principle of cost or market, whichever is lower, was extended to the marketable securities held in the Sinking and Reserve Fund on December 31, 1907.

An example of accountants' interest in this policy of conservatism was Walton's feeling that the "conservative man" would not realize profits until the selling process was completed and would keep the inventory value at cost unless there was a downturn in the market prices for different types of raw materials. The careful auditor would insist upon this policy, for it was better to be pleasantly surprised than to be disappointed. If there were an error, it would be on the safe side.[7] The use of the "cost or market, whichever is lower" rule by management was in tune with the accounting principle stated by Walton.

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[7] Walton, Auditing, p. 56.

A very significant departure from past practice occurred in 1904. The intercompany profit in inventory was removed from the calculation of net earnings for the year, and the amount of intercompany profits in inventory as of December 31, 1903, was taken from the balance of Undivided Surplus as of that date and reclassified as a separate part of that statement. (Refer to Table 1 in the Appendix for this chapter.) This change in accounting policy had been heralded in the 1903 Annual Report. The policy change was stated in the 1903 Annual Report to be conservative and safe. It was reported to be a radical change from current practice, but one that would put earnings more closely in tune with the cash basis. This policy represented a middlepoint between the non-recognition of intercompany profits in inventory until sale to outsiders and the previous policy of recognizing income when inventory items were sold to other divisions of the United States Steel Corporation. The net earnings for the year were not affected by this item but the total of the Undivided Surplus Account remained the same. An accounting writer held that while the inclusion of intercompany profits in inventory was accepted by accountants on the basis of convenience, care was to have been exercised so that dividends were not paid from these

profits.[8] It appeared that management of the United States Steel Corporation was willing to have been more conservative than the accounting writer on this matter.

Another sign of conservatism was the recognition of only one-half the estimated profits on uncompleted bridge and structural contracts in 1903. It appeared that 100 per cent of the estimated profits for work in process, as far as the work had progressed, was included in the 1902 Annual Report. A major revision of accounting policy occurred in 1911. The Undivided Surplus Account was reduced by the amount of intercompany profits in inventory and the inventory amount on the balance sheet was decreased by the amount of intercompany profits in inventory.

An example of normalizing income and/or de-watering was the shifting of the charge for the Appropriation for Property Expenditures Made or Authorized from the Undivided Surplus Account to the Income Account in 1905. The yearly addition to the Undivided Surplus Account was thus substantially lower than if these charges had been made against the Undivided Surplus Account. There were two Sinking and Reserve Funds accounts credited for these

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[8] Montgomery, ed., Administration, pp. 1003-4.

charges until 1909, when the balance of the one account still open was transferred to an account entitled Appropriated Surplus to Cover Capital Expenditures. The charges made to the Income Account from 1905 through 1910 amounted to $105,300,000 for Additional Property and Construction and Discharge of Capital Obligations and $65,000,000 for Contemplated Appropriations and Expenditures.

A financial writer stated that it was impossible to pay out the entire amount of profits each year to stockholders, because of the fact that no stock could attain the investment ("blue-chip") status without a regular distribution of profits. A surplus reserve must be established before dividends were distributed to stockholders. The amount so reserved (the financial writer confused a surplus reserve with a fund) might be invested in plant and equipment.[9] He stressed:

> In no other way can a corporation, the permanence of whose earning power is in any way doubtful, so certainly reach an investment position as by a resolute adherence to the policy of reserve accumulation, and a refusal to pay dividends until its ability to continue paying dividends is unquestioned.

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[9] Meade, <u>Trust Finance</u>, p. 159.

> This process of salvation may be tedious, but it is certain. No matter how inflated the capitalization of a new company, no matter how threatening the danger of competition, no matter how irregular the demand for the product, the steady investment of profits in surplus earning power will in time build a solid foundation of productive assets, upon which, slowly though it may be, conservative management will rear a structure of investment value.[10]

Accounting writers also stressed the importance of reserves established from earnings so to normalize earnings and/or de-water the original overcapitalization. Conservative management would not issue all the profits as dividends but would apply a large sum of such earnings to new construction so as to "squeeze out" the water.[11] Profits were not to be considered distributable unless (1) the profits could reasonably be expected to recur under normal conditions, (2) the dividend rate could be continued and large renewal demands, for which no provision had been set aside, would not absorb the profits of future years,

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[10] Ibid., p. 159.

[11] William M. Lybrand, "The Accounting of Industrial Enterprise, Part III," The Journal of Accountancy, 7 (January, 1909), 231.

and (3) future years were to be charged on a fair basis for all renewals necessary for the operation of the business.[12]

It is interesting to note the extent to which management had de-watered the United States Steel Corporation by the end of 1910. The Bureau of Corporation's study traced the gradual de-watering of the assets of the United States Steel Corporation through 1910. The ten ending balance sheets and the April 1, 1901, balance sheet were presented in a significantly different manner than in the annual reports. The Bureau of Corporations adjusted depreciation charges and arrived at an estimated "true" depreciation figure for the year. The revised balance sheets included no reserve or surplus accounts; the amounts in these accounts were treated as being reductions of the Intangible Considerations and Water classification. One noted that from April 1, 1901, to December 31, 1910, the United States Steel Corporation had reduced this classification from $721,328,839 to $281,671,574.[13] (Refer to Table 2 in the Appendix for this chapter.)

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[12] Montgomery, ed., Administration, pp. 1006-7.

[13] Report of the Commissioner of Corporations on the Steel Industry: Part I, pp. 328-9.

It appeared that the United States Steel Corporation's policy to normalize earnings and/or to de-water was in tune with recommendations from a financial writer and accounting writers. The United States Steel Corporation took such action, even though the yearly addition to the Undivided Surplus Account was materially decreased over the amount that it would have been if a less conservative policy were followed. The United States Steel Corporation definitely did not attempt to create a feeling of overconfidence in the stockholder with this policy. It could have increased the dividends in the short run but it chose another alternative.

Comparative Income Accounts

The 1903 Annual Report contained a comparison of the Income Accounts for 1902 and 1903. (Refer to Table 3 in the Appendix for this chapter.) Such information was probably available in such financial sources as Moody's Manual of Corporation Securities, Poor's Manual, and the Financial Chronicle. Charles Dow referred his readers to these manuals for an examination of past records, which could be updated by the current earnings reports in the

Wall Street Journal.[14] The aforementioned sample (refer to page 23) of the first thirty industrial stocks listed in the 1903 Poor's Manual showed that comparative data for income was presented for seven of these thirty companies.[15] Of a non-selective sample of the data included for ten railroad companies in the 1903 Poor's Manual, eight of the railroads analyzed had at least a two-year comparison of the Income Account and the other two had just the current Income Account stated.[16] An accounting writer stressed the fact that the comparison of one year's income statement to the preceding one would yield clues as to profit improvement.[17] It appeared that the United States Steel Corporation's Comparative Income Accounts was in line with the example set by the financial services and the recommendation of an accounting writer.

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[14] Bishop, Charles H. Dow and the Dow Theory, p. 124, paraphrasing an August 9, 1902, editorial from the Wall Street Journal.

[15] Poor's Manual 1903, pp. 1138-39.

[16] Ibid., pp. 19-307.

[17] George Lisle, Accounting Theory and Practice (Edinburgh and London: William Green & Sons, 1900), p. 49.

The Relationship Between Depreciation and Production

An indication of the basis for the provision for depreciation was noted in the Certificate of Chartered Accountants in the 1908 Annual Report. The firm of Price, Waterhouse & Company stated in their certificate that the curtailment of operations during the year necessitated a reduction in the amount of depreciation for the year. With 13,099,548 ingots of steel produced in 1907, depreciation charges amounted to $27,719,744.44. With 7,838,713 ingots of steel produced in 1908, depreciation charges were $16,965,181.46.

The relationship between depreciation and production had been stressed by such accounting authorities as Erving Matheson and Francis Pixley. Both these writers presented a case for the employment of what is labeled today as the units-of-production method of depreciation. Matheson stressed that the busy times brought on by the pressing demands for goods forced the use of plant and machinery to their utmost. Plant and machinery might even be run in the face of possible breakdown so that firms could supply the insatiable demand. For such instances, the amount

charged for depreciation should correspond with this use.[18] Pixley stressed the importance of the length and severity of usage as factors in the establishment of the annual depreciation charge.

> In considering the amount to write off for depreciation in respect of engines and boilers, other points have also to be borne in mind. Both engines and boilers, if worked at great pressure, cannot last the same length of time as if more gently used. The number of hours they are used must be taken into consideration also, as where double shifts of workmen are employed, the engines cannot last as long as where men work only single shifts.[19]

William J. Filbert, Comptroller of the United States Steel Corporation, in an answer to a query during a conference with the Commissioner of the Bureau of Corporations reflected the United States Steel Corporation's policy in regards to depreciation. He stated, "Depreciation is not the same amount year by year,

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[18] Matheson, The Depreciation of Factories, p. 39.

[19] Pixley, Accountancy, p. 212.

you know. If you don't run your plant, your depreciation is not as great."[20]

It appeared that the management of the United States Steel Corporation was in agreement with these accounting writers on the issue of matching depreciation with production. The statement of the policy of depreciation gave the readers of the annual reports an important clue as to management's depreciation policy.

Revision of the Condensed General Profit and Loss Account

There was a major revision of the Condensed General Profit and Loss Account in the 1908 Annual Report. (Refer to Table 4 in the Appendix for this chapter.) This revision gave one a clearer picture of operating income than before. While a gross profit amount was not highlighted, it undoubtedly was the result of subtracting the Manufacturing and Producing Cost and Operating Expenses amount from the amount of Gross Receipts. Operating income

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[20] Rough Memorandum of Conversation during Conference between W. J. Filbert, of the United States Steel Corporation, and the Commissioner, Dr. Walker, and Mr. Conant, May 24-26, 1911, Inclusive, Concerning the Bureau's Investigation of the Steel Industry, File 2604-1-6, U. S., Bureau of Corporations, National Archives, p. 21.

appeared as an amount not affected by the Other Income items. This clear portrayal of operating income had been stressed by George Lisle.[21] The revised Condensed General Profit and Loss Account resembled the form of the profit and loss account recommended by Arthur Lowes Dickinson in a 1904 article.[22] It appeared that the United States Steel Corporation's modification of its Condensed General Profit and Loss Account was in tune with these accounting writers.

Financial Accounting Aspects of the Federal Tax on Income

The Corporate Excise Tax of 1909 was regarded as the key event which officially recognized the practice of depreciation.[23] The United States Steel Corporation had always recognized depreciation as an expense--or, more accurately, as an appropriation of earnings. However, as

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[21] Lisle, Accounting in Theory and Practice, pp. 55-6.

[22] Dickinson, "The Profits of a Corporation," 188-9.

[23] DeMond, Price, Waterhouse & Company in America, p. 84.

already mentioned (Refer to page 37), the depreciation reserve accounts had been classified as a section of the liability part of the Balance Sheet. Commencing with 1910 Annual Report, the United States Steel Corporation reclassified these reserve accounts as a reduction from the Property Account. It was explained thusly:

> In the Consolidated Balance Sheet included in this report as of December 31, 1910, a change has been made as compared with previous years' balance sheets as to location therein of the accrued depreciation and replacement fund reserves and of the account Bond Sinking Funds with Accretions. These funds being reserved from earnings and income to cover acquiring amortization and depreciation in respect of the assets included in the Property Investment Account, it has been considered advisable to state the balances thereof in the balance sheet as a credit in connection with the gross property investment rather than to show them on the liability side of the balance sheet, as has been done in previous years.

From where did the liability for depreciation arise? When did it mature? For whom was the corporation liable for these reserves? These questions typified the change from the liability viewpoint of the depreciation reserves to the contra-asset viewpoint. New emphasis was placed on

a plant ledger which included the cost of each fixed asset item and accumulated depreciation on each item.[24]

It appeared that this change in accounting policy was caused by the recognition that depreciation was a function of the property account and not a function of the funds or reserves needed to replace, restore, or modernize such assets. This recognition was undoubtedly spurred by the Bureau of Internal Revenue regulation that depreciation should be an estimate based on the property's assumed life, its cost, and its use.[25]

The United States Steel Corporation had adopted a policy of treating appropriations for property as a permanent part of the capital structure of the firm and, as such, the account was not charged for the expenditures made for property purchased for the appropriation. Since the first appropriation under this policy was made from the 1909 Annual Report, it was probable that the desire to maintain the property account on a cost basis for depreciation purposes was the governing factor.

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[24] Herbert G. Stockwell, "Depreciation, Renewal and Replacement Accounts," The Journal of Accountancy, 9 (January, 1910), 197-203.

[25] U. S., Department of the Treasury, Office of the Commissioner of Internal Revenue, T. D. 1571, pp. 9-10.

It appeared that the corporate income tax administration by the Bureau of Internal Revenue was a factor in financial accounting changes in the United States Steel Corporation.

<u>Summary Assessment</u>

Most of the topics of this era were matters of concern for accounting groups. The warning of Price, Waterhouse & Company's senior partner in America about concealing charges in the surplus account was not heeded by the United States Steel Corporation. Accounting writers contributed to the climate of conservatism. The United States Steel Corporation's presentation of the Comparative Income Accounts was in line with the recommendation of an accounting writer, as well as with the issues of matching the amount of depreciation with the level of production and the format of the Condensed General Profit and Loss Account.

A financial writer, the financial services, the Bureau of Internal Revenue, and stockholders were also involved with some of these financial accounting topics. A leading financial writer contributed to the climate for normalizing earnings and/or de-watering the original valuation of the United States Steel Corporation by his strong plea for surplus reserves. The financial services set an example for the issuances of Comparative Income

Accounts. The Bureau of Internal Revenue administration of the federal corporate income tax apparently influenced a revamping of the United States Steel Corporation's financial accounting.

The management of the United States Steel Corporation was again very prominent in this era on such matters as the utilization of the Undivided Surplus Account and conservatism. Its financial accounting policies undoubtedly did not cause overconfidence among its stockholders.

CHAPTER IV

WORLD WAR I AND THE RETURN TO NORMALCY

1916-1929

Historical Résumé and Synopsis of Financial Accounting Events

The United States experienced the beginnings of the World War I boom in January, 1915, when war orders started flowing in from Europe. Approximately five billion dollars of foreign funds were poured into the economy. Very ineffective measures of control of the wartime economy were exercised by the federal government until we entered the war in 1917. Some control was then required because of the very significant increase in the demand for workers and material. The chief governmental control agency was the War Industries Board, which was founded on July 8, 1917. It had two very important functions--the rationing of scarce material and workers and the fixing of prices. Most of the price fixing was the result of voluntary

compliance rather than administrative edict.[1] Almost all schedules of fixed prices were reached by negotiation between the government and the industry involved.[2] Since prices were set so that the higher cost producers would be encouraged to produce, these prices led to very significant profits for certain firms. The federal government tried to tax away these profits by an excess profits provision in the Revenue Act of 1917.[3]

The increased demand for workers, the withdrawal of 4,000,000 men into the armed forces, and the cessation of immigration led to a serious labor problem. The rapidly rising cost of living and the labor turnover situation were two other facets in the labor problem. The War Industries

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[1] George Soule, Prosperity Decade: From War to Depression: 1917 to 1929, The Economic History of the United States, Vol. VIII (New York and Toronto: Rinehart & Company, Inc., 1947), pp. 8-22.

[2] Chester W. Wright, Economic History of the United States (New York and London: McGraw-Hill Book Company, Inc., 1941), p. 935.

[3] Soule, Prosperity Decade, pp. 18-20.

Board established a Committee on Labor to aid the Board in labor problems in the industries with which it dealt.[4]

The war boom continued after the war until the middle part of 1921. However, a serious postwar depression occurred in 1921. The wholesale price index fell from 227.9 in 1919 to 150.6 in 1921. There were 4,750,000 workers unemployed. Gross National Product in terms of 1914 dollars fell from $40.1 billion in 1920 to $37.6 billion in 1921. The nation began its recovery from the 1921 depression in 1922. The period from 1922 through 1929 was marked by a very stable price level. Industrial production, according to the Federal Reserve Board Index, rose from 58 in 1921 to 110 in 1929. National income increased from $56.5 billion in 1921 to $87.1 billion in 1929.[5]

Topics discussed in this chapter are the financial accounting adaptation made by the management of the United States Steel Corporation, the question of price justification and financial accounting, the treatment of

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[4] Wright, Economic History of the United States, pp. 945-7.

[5] Soule, Prosperity Decade, pp. 83-107.

common stock transactions, and the use of the Undivided Surplus Account.

Financial Accounting Events

Continuation of Conservatism

The wartime conditions brought a continuation of the financial accounting policy of conservatism by the United States Steel Corporation. An inventory reserve and a direct credit to the property account for the excess cost of fixed assets acquired during the high cost years from 1917 to 1920 were representative of balance-sheet conservatism. (The income-statement effect of these two examples of balance-sheet conservatism is discussed in the section on Price Justification in this chapter.) The use of a contingency reserve was probably indicative of the desire to normalize earnings. The normalization of income and/or de-watering policy was continued by the appropriations from the Income Account and the Undivided Surplus Account.

The first financial accounting indications by the United States Steel Corporation of the economic effects of World War I occurred in the 1916 Annual Report. A Reserve for Amount of Actual Cost or Market Values of Stocks in Excess of Normal Prices therefore of $13,524,794.00 was established and credited to the inventory account. This

amount was treated as a deduction to arrive at total earnings on the Condensed General Profit and Loss Account. The reasoning for this reserve was that businessmen felt that the inventory cost represented an amount that was abnormal and that would not be sustained once normal conditions returned. The additional inventory cost was not held to be a permanent one.[6] Price, Waterhouse & Company noted in its certificate "that an adequate reserve has been made in respect of all abnormal values." Additional increases to this reserve were $16,746,000 in 1917, $19,018,000 in 1918, $38,722,000 in 1919, and $5,000,000 in 1920. The substantial deflation of 1921 and 1922 resulted in reductions of $34,289,746 in 1921 and $11,250,173 in 1922 in the inventory reserve account.

The annual reports gave no clue as to whether the Bureau of Internal Revenue had accepted this method of inventory valuation for tax purposes. It appeared that the Bureau of Internal Revenue disapproved of this reserve

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[6] T. H. Sanders, "Some Variations in Inventory Valuations," The Journal of Accountancy, 42 (December, 1926), 437.

and the base stock method of inventory which this reserve implied.[7]

It appeared that management reacted very quickly to the matter of the inflation of this era. Management appeared to be willing to take a financial accounting position different from the position taken by the Bureau of Internal Revenue on the question of tax-deductibility. Management used this reserve to dampen stockholder confidence during the high inflation years from 1916 to 1920 and buoy it during the two years of deflation.

In addition to the aforementioned reserve for inventory costs, an additional charge was made For Other Contingent Reserves of $2,100,000 in 1916, and $13,000,000 in 1917. These reserve entries were undoubtedly made with the goal of normalizing income.

In 1917, a charge was made to the General Profit and Loss Account for $29,785,000 for an Allowance for Estimated Proportion of Extraordinary Cost of Facilities Installed by Reason of War Requirements and Conditions. This amount was credited to the property account. This practice was continued for the next three years:

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[7] Ibid., 437-8.

$40,000,000 in 1918, $38,297,853.74 in 1919, and $27,000,000 in 1920. With the property account figure materially lower with these direct credits, management definitely did not mislead its stockholders in the direction of overconfidence during these years. Montgomery's statement that "In deciding whether an expenditure should be capitalized or charged as an expense, it is better to be conservative than accurate" was apparently the maxim for this situation.[8]

The boom associated with the war effort brought increased profits to the United States Steel Corporation. There was a continuation of the practice of appropriations from the Income Account and from the Undivided Surplus Account. In 1917, $55,000,000 was Appropriated from Net Income on Account of Expenditures Made and To be Made or Authorized Appropriations for Additional Property, New Plants and Construction, and $4,000,000 was appropriated from the Undivided Surplus Account for the permanent pension fund. In 1918 $12,215,000 was appropriated for the excess cost of wartime construction from the Income Account.

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[8]Robert H. Montgomery, "Influence of the War on Balance Sheets," The Journal of Accountancy, 28 (July, 1919), 4.

The policy of appropriations from the Income Account continued during the mid 1920's; $20,000,000 was appropriated for additions, improvements or betterments to plants and property in 1924; $25,000,000 was appropriated in 1925 for the same purpose; $30,000,000 was the appropriation for it in 1926.

It again appeared that management was very willing to accept and apply the doctrine of normalizing of net income and/or de-watering espoused by both financial and accounting writers.

Price Justification

An important example of management and an accounting professional body attempting to influence their environment was the issue of the cost justification of prices during the war years. While the War Industries Board did set prices by agreement with the firms in an industry, the Federal Trade Commission collected cost information from the producers so that the War Industries Board could determine the highest necessary cost for fulfilling production goals.[9] The Federal Trade Commission was

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[9] U. S., Federal Trade Commission, Report of the Federal Trade Commission on War-Time Profits and Costs of the Steel Industry (Washington, D. C.: Government Printing Office, 1925), p. 1.

founded by Congress in 1914 to enforce the Clayton Act and assimilated the United States Bureau of Corporations.[10]

A memorandum submitted to the Federal Trade Commission by a group of steel producers was reprinted in an editorial entitled "Determination of Cost" in The Journal of Accountancy. The memorandum dealt with the questions of inventory cost and selling price to the government.[11] An interesting feature of the memorandum was the close similarity to the form of the Condensed General Profit and Loss Account of the United States Steel Corporation in 1917 and 1918. It appeared that the financial accounting presentation of the United States Steel Corporation in 1917 and 1918 was an attempt to justify its pricing policy.

The inventory reserve has already been discussed from the point of view of reducing the inventory amount to normal prices. The creation of the charge to the Condensed

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[10] U. S., Federal Trade Commission, Annual Report of the Federal Trade Commission for the Fiscal Year Ended June 30, 1915 (Washington, D. C.: Government Printing Office, 1915), pp. 1-2.

[11] "Determination of Cost," The Journal of Accountancy, 24 (September, 1917), 215-22.

General Profit and Loss Account could also be viewed as representing the higher replacement cost required to restock materials used in war production. A manufacturer who obtained raw materials at a lower cost and whose profit was to be determined as a percentage of cost would be at an unfair advantage with a manufacturer who had procured material at the current price.[12] This procedure would have allowed a steel manufacturer to charge an amount higher than the cost of the inventory item as a component of the cost of the contract.

A similar situation existed with fixed assets purchased or constructed during the war period. Since these assets were built for the war period and might not be worth their inflated cost when the wartime emergency ended, it was held that the federal government should allow an amortization of this excess cost in the pricing formula. This procedure had been granted to manufacturers in England.[13] The aforementioned Allowance for Estimated Proportion of Extraordinary Cost of Facilities Installed by Reason of War Requirements and Conditions in 1917 and 1918 could also be explained as an attempt to justify prices,

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[12] Ibid., 218.

[13] Ibid.

as these charges were included in the income statement of the United States Steel Corporation.

In addition to the allowances for additional costs due to wartime conditions, greater amounts of depreciation were to be allowed for pricing purposes.

> Thus, the more intensive use of a plant, the lower average of efficiency on the part of the employees resulting from the necessity of employing largely increased forces, the postponement of repairs in preference to the suspension of operations, and other factors which cannot perhaps all be specified, will affect the operating conditions and should be taken into account in determining the reasonable provision for depreciation.[14]

This statement was very similar to the United States Steel Corporation's policy towards depreciation described in the last chapter. (Refer to page 75.)

The United States Steel Corporation had never segmented its Operating Charges and hence a cost of goods sold figure never appeared on the Condensed General Profit and Loss Account. This policy appeared in line with the view expressed in the memorandum that selling and

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[14] Ibid.

administrative expenses were a general burden which must be distributed over the cost of the entire product. Only specific and direct selling expenses, like commissions, should not be included in the general burden of selling, general, and administrative expenses. Any other attempt at breaking down these costs as billable and non-billable would be enormously expensive and not worth the cost in terms of equity and accuracy.[15]

While it was agreed that the federal income and excess profits taxes were not to be considered as a part of the cost of production, the memorandum held that these taxes should be a component of the selling price so that a fair net profit could be ascertained. Reference was made to the British situation, in which that country's special war tax was allowed as a cost in the process of ascertaining a selling price.[16] The separate listing of the federal income and excess profits taxes and their inclusion as an Operating Charge could be viewed from the context of cost/price justification.

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[15] Ibid., 220.

[16] Ibid.

The willingness of the American Institute of Accountants to print such an industry proposal as an editorial in The Journal of Accountancy placed it in the position of being a proponent of industry.

The Use of the Undivided Surplus Account

Relatively minor amounts had been charged or credited to the Undivided Surplus Account since the 1904 Annual Report. However, a very significant number of entries were made in this account in the last few years of this era. The detail of the explanations and the amounts of these entries were important factors in the answer to the question of how management utilized its leeway with respect to financial accounting.

The 1926 Annual Report contained surplus entries concerning the matter of the redetermination of the excess profits tax paid to the federal government during and shortly after the war. The United States Steel Corporation undoubtedly had filed a claim for a redetermination of its invested capital and had adjusted its depreciation reserve by a credit of $40,179,030.23 in the process. Many thousands of claims for the excess profits tax years of

1917 and 1921 were filed.[17] The Surplus Account was credited for an amount of $17,442,160.14 for the Net Adjustment of Federal Tax, Depletion, and Depreciation Reserves of Previous Years in Connection with Redetermination of Invested Capital and Requirements for Such Reserves. Then $11,669,422.47 was deducted from this amount for appropriations for capital and expenditures made, leaving a net increase in the Surplus Account of $5,772,737.67. The basis for this adjustment and the accounts affected were not clear at all from an examination of the 1926 Annual Report.

In 1928, the Undivided Surplus Account was increased for Federal Income and Excess Tax Refunds, and Reserve No Longer Required. This amount was offset by a like amount for two appropriations from Surplus for $6,500,000 for an Addition to Depreciation Reserves for General Obsolescence and Adjustment to Prior Years Depreciation Accruals, and $30,205,076.23 for Account Amortization of Appreciated Cost to the United States Steel Corporation of

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[17] U. S., Department of the Treasury, Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1924 (Washington, D. C.: Government Printing Office, 1925), p. 289.

its Investment in Capital Stocks of Subsidiary Companies in Excess of Their Investment in Tangible Property. The 1929 Undivided Surplus Account contained so many (6) entries that the writer included the Account as Table 1 in the Appendix for this chapter. Another credit, the Undivided Surplus Account for an income and excess profits tax refund for $18,322,393.07, occurred in 1930.

The issue of using the surplus account for extraordinary items was not a settled matter at that time. The American Institute of Accountants, in a memorandum to the Federal Trade Commission concerning balance sheet audits, recommended that unusual or extraordinary items of profit or deductions be included in the surplus statement.[18] This memorandum was approved by the Federal Trade Commission and forwarded to the Federal Reserve Board for submittal to banks, bankers, and banking associations throughout the country.[19]

Robert Montgomery held differently. He stated that extraordinary items affecting prior periods should be

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[18] U. S., Federal Reserve Board, "Uniform Accounting," <u>The Journal of Accountancy</u>, 23 (June, 1917), 429.

[19] <u>Ibid</u>., 403.

included as the final category in the determination of net income on the income statement.[20] It was stated in the Accountants' Handbook that extraordinary items should be carried to the surplus account or to a separate section of the profit and loss account, so that results for the current period can be utilized for comparative purposes.[21] H. A. Finney held that the profit and loss account should only show the results of current operations so that the normal earning power of the company would be shown.[22] Dickinson took the more restricted view that only extraordinary items affecting no one particular year be included in the surplus account and that ordinary income and expense items of past periods that were omitted or included in error be treated in the Income Account.[23]

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[20] Robert H. Montgomery, Auditing: Theory and Practice (4th ed.; New York: Ronald Press Company, 1927), p. 356.

[21] Earl A. Saliers, ed., Accountants' Handbook (New York: Ronald Press Company, 1924), p. 305.

[22] H. A. Finney, Principles of Accounting, Vol. I (New York: Prentice-Hall, Inc., 1927), Chapter 2, pp. 2-3.

[23] Arthur Lowes Dickinson, Accounting: Practice and Procedure (2nd ed.; New York: Ronald Press Company, 1922), pp. 66-8.

Certain of the items entered in the Undivided Surplus Account for these years could be classified as extraordinary items. Items such as refunds for prior periods taxes, adjustments to prior years reserves for taxes, and premiums on bond retirement were of this nature. The other items entered in the Undivided Surplus Account for this time span appeared to indicate the management's desire to de-water the assets. The write-off of $11.7 million dollars in 1927 for capital expenditures made and the $36.7 million in 1928 for increased depreciation reserves and amortization of appreciated cost reduced the property account. The reduction of the Undivided Surplus Account in 1929 for the $88.6 million of amortization of appreciated cost and for the $25 million of the organizational working capital was tied into a schedule which highlighted the fact that the United States Steel Corporation had finally reserved enough from operations to match the par value of common stock issued at the inception of the corporation. There was $182 million which had been accumulated as a credit in the Bond Sinking Fund Reserve; $208 million had been credited to the property account as direct reductions of Surplus; $118 million had been credited to the Property Account in the last two years. This total of $508 million equaled the par value of common stock issued on April 1, 1901.

The Bond Sinking Fund Reserve Account, the $80 million amortization credit of 1929, and the $25 million working capital surplus were directly subtracted from the Gross Fixed Property Investment Account in 1929. This was, in effect, a write-down of $295 million to the Gross Fixed Property Investment Account. This was one of the methods suggested by Finney to achieve the elimination of water.[24]

No mention was made in the Annual Report that the write-down was caused by the chaotic stock market conditions of the time. There appeared to be encouraging signs that the worst was over. It was reported in the 1929 Annual Report that there was a significant improvement in new orders for the first three months of 1930.

The differences of opinion among accounting authorities as to the utilization of the Undivided Surplus Account left management with the opportunity to utilize the account in a manner relatively uninhibited by accounting influences. It would be quite difficult to speculate upon the effect this policy of management had on the overconfidence of stockholders, because of the fact

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[24] Finney, Principles of Accounting, Vol. I, Chapter 7, pp. 11-2.

that the entries probably confused them. It appeared that the matter of the redetermination of invested capital of the United States Steel Corporation, so as to adjust the excess profits tax, was approved by the Bureau of Internal Revenue. The accounting entry made to adjust the depreciation reserve account was probably an example of modifying the corporation's records to reflect tax accounting.

Textbook Handling of Common Stock Transactions

The financial accounting treatment for two common stock transactions followed the prescribed method recommended in a leading accounting and a leading finance textbook. The reliance upon accounting texts for accepted accounting methods became even more pronounced during the depression and probably was indicative of a better defined body of accepted practices in financial accounting.

A 40 per cent stock dividend for the common stockholders was issued on June 1, 1927. The amount of the stock dividend, $203,321,000.00, was taken from the Undivided Surplus Account and added to the common stock portion of capital stock. This method of accounting appears to have been the accepted way of handling the transaction. Dewing stated that a stock dividend was

merely a transfer to the par value of the stock issued.[25] Finney held that a stock dividend just reduced surplus and transferred that reduction to the capital stock account.[26]

In 1929, common stock with a par value of $101,660,500 was purchased by stockholders for $142,607,624.50. A new account appeared in the balance sheet; it was entitled Premium on Common Stock Sold with a balance of $41,037,124.50, and was a part of the Reserves and Surplus section. This handling again represented the accepted method.[27]

An interest in accepted accounting practices was expressed in 1927 by Professor William Z. Ripley in his work Main Street and Wall Street, in which he devoted over thirty pages to various questionable accounting practices of American corporations.[28] An accounting writer reported

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[25] Arthur Stone Dewing, Corporation Finance (New York: Ronald Press Company, 1922), p. 182.

[26] Finney, Principles of Accounting, Vol. I, Chapter 9, p. 9.

[27] Dewing, Corporation Finance, p. 152; Finney, Principles of Accounting, Vol. I, Chapter 7, p. 14.

[28] William Z. Ripley, Main Street and Wall Street (Boston: Little, Brown, and Company, 1927), pp. 171-206.

that accountants, impressed by Ripley's findings and suggestions, utilized the American Institute of Accountants as a vehicle to attempt to have a joint committee established between the American Institute of Accountants and the New York Stock Exchange in 1927. This attempt was unsuccessful, as there was a lack of support among the members of the New York Stock Exchange for the committee.[29] While the New York Stock Exchange did not establish a committee to work with the American Institute of Accountants on accepted accounting principles until 1930, in May, 1928, the Committee on Stock List commenced employing consulting accountants for the purpose of referral for opinion and advice on questions of accepted accounting principles.[30]

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[29] J. R. Taylor, "Some Antecedents of the Securities and Exchange Commission," The Accounting Review, 16 (June, 1941), 193.

[30] Committee on Stock List, "Historical Account of Relationship of New York Stock Exchange with Listed Companies as it affects Accountants," p. 2.

Summary Assessment

Accounting forces did not appear to be as influential during this period as in the previous and subsequent periods. This period was marked by the American Institute of Accountants apparently following the lead of the steel industry in the topics of wartime conservatism and price justification. Accounting authorities had not yet agreed on the issue of the utilization of the surplus account and thus permitted management wide leeway in this issue. There appeared, however, to have been developing accepted accounting treatments for various matters. This movement continued with more emphasis during the next era.

Limited interest was also shown by the other institutional groups. A financial writer agreed with the accepted manner of handling common stock transactions. The Bureau of Internal Revenue was probably influential in obtaining a financial accounting adjustment for the revision of the United States Steel Corporation's invested capital. However, there appeared to be a willingness not to follow the Bureau of Internal Revenue's rulings on tax matters for financial accounting. The New York Stock Exchange began to show an interest in accepted accounting principles.

Management was probably the strongest, in regards to financial accounting matters, in this era than in any preceding or subsequent era. The United States Steel Corporation was swift in its financial accounting adaptations to wartime conditions. The management of the United States Steel Corporation undoubtedly played a very strong role in the development of the steel industry's memorandum on cost and price justification and, as such, showed its financial accounting strength apparently by having the American Institute of Accountants reprint the memorandum as an editorial. The United States Steel Corporation's use of the Undivided Surplus Account undoubtedly confused the stockholders.

Two questions from this chapter that will be raised again in this work and might be raised for today's financial accounting are: (1) should an accounting professional body be industry proponents, and (2) is there too much management leeway granted in certain financial accounting matters?

CHAPTER V

THE DEPRESSION

1930-1940

Historical Résumé and Synopsis of Financial Accounting Events

The most telling fact about the period from 1930 to 1940 is that not once in this period did the Gross National Product of the United States attain the level it did in 1929.[1] Economic revival from the depression began with the outbreak of the war in Europe in 1939.[2] This

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[1] U. S., Department of Commerce, The National Income and Product Accounts of the United States, 1929-1965, Statistical Tables (Washington, D. C.: Government Printing Office, 1966), pp. 2-3.

[2] Broadus Mitchell, Depression Decade: From New Era through New Deal, 1929-1941, The Economic History of the United States, Vol. IX (New York and Toronto: Rinehart & Company, Inc., 1947), p. 371.

period marked the birth of the Securities and Exchange Commission, a New Deal agency concerned with the ensuring of "Truthfulness in the offering of securities and honesty and openness in trading on the exchanges."[3] The Securities Act of 1933 had granted the Federal Trade Commission this responsibility, but the responsibility was transferred on September 1, 1934, to the Securities and Exchange Commission by the Securities Exchange Act of 1934.[4] The scope of the financial accounting aspects of the Securities and Exchange Commission can best be obtained from the responsibilities delegated to its Chief Accountant. His responsibility included: (1) rendering advisory services to the Commission in regards to accounting theory, policy and procedures; (2) conferences with accounting authorities and the staff of the Securities Exchange Commission in regards to drafting and interpreting accounting rules and regulations; (3) the supervision over the issuance and administration of rules regarding uniform

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[3] Ibid., p. 172.

[4] U. S., Federal Trade Commission, Annual Report of the Federal Trade Commission for the Fiscal Year Ended June 30, 1934 (Washington, D. C.: Government Printing Office, 1934), p. 2.

classification of accounts; and (4) the drafting of procedures to be followed in the conducting of audits.[5]

During this period, the federal government through the National Labor Relations Board removed some of the most serious obstacles to unionization.[6] In 1937, as reported in the 1937 Annual Report, the United States Steel Corporation entered into labor contracts with the Steel Workers Organizing Committee which was the collective bargaining agent for employees who belonged to the Amalgamated Association of Iron, Steel and Tin Workers of North America.

The American Institute of Accountants began to display increased interest in this period in the topic of accounting principles.[7] Correspondence between the

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[5] U. S., Securities and Exchange Commission, Second Annual Report of the Securities and Exchange Commission: Fiscal Year Ended June 30, 1936 (Washington, D. C.: Government Printing Office, 1936), p. 7.

[6] Wright, Economic History of the United States, p. 755.

[7] Reed K. Storey, The Search for Accounting Principles: Today's Problems in Perspective (New York: American Institute of Certified Public Accountants, Inc., 1964), p. 3.

American Institute of Accountants Committee on Cooperation with Stock Exchange and the Committee on Stock List of the New York Stock Exchange reflected the concern about the topics of accepted accounting principles, consistency, audit standards and other accounting topics.[8] Sanders, Hatfield, and Moore completed a codification of generally accepted accounting principles and this study was published by the American Institute of Accountants in 1938.[9] The Committee of Accounting Procedure of the American Institute of Accountants began issuing Accounting Research Bulletins, which attempted to define generally accepted accounting principles, in September of 1939.[10]

The American Association of University Instructors was renamed the American Accounting Association in 1935

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[8] American Institute of Accountants, Audits of Corporate Accounts, pp. 1-32.

[9] Thomas Henry Sanders, Henry Rand Hatfield, and Underhill Moore, A Statement of Accounting Principles (New York: American Institute of Accountants, 1938), foreward.

[10] American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins: Final Edition (New York: American Institute of Certified Public Accountants, 1961), p. 135.

and planned to take a more active role in the formulation of organized research in accounting theory.[11] The American Accounting Association published in 1936 A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements, in which an attempt was made to present an experimental formulations of accounting principles.[12]

Topics included in this chapter are the reporting of figures for earnings per share and working capital, the movement towards the delineation of accepted accounting principles, and the question of reserve and inventory accounting during the depression. Other events discussed are the write-down of fixed assets, the utilization of the Surplus Account, the accounting treatment of intangibles, the auditor's scope paragraph, and the format of annual reports.

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[11] "Convention Report," The Accounting Review, 11 (March, 1936), 75-6.

[12] American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements (Iowa City, Iowa: American Accounting Association, 1957), p. 60.

Financial Accounting Events

Earnings per Share and Portrayal of Working Capital

Both of these topics centered around influences of financial sources and, for this reason, are included in one section. There was another similarity present in that there was a considerable time lag between the United States Steel Corporation portrayal and publication of these items in a financial service.

The first mention of earnings per share in the annual reports of the United States Steel Corporation occurred in the 1930 Annual Report, in which the caption Earnings per share on Common Stock (on average shares outstanding) of $9.18 was included on the first page of the report at the bottom of the Consolidated Income Account for the year. Poor's and Moody's Manual had included the yearly earnings per share figure for the United States Steel Corporation within a five-year comparison of prior earnings per share starting with its 1923 issue.[13]

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[13] Poor's and Moody's Manual: Consolidated: 1923: Industrial Section, Vol. II, K to Z (New York: Poor's Publishing Co., 1923), p. 558.

An accounting writer stated that there was no standard formula for computing earnings per share. There was no problem when the number of shares outstanding did not change but a difference of opinion existed in accounting circles as to the treatment of increases in the number of shares outstanding during the period.[14] An editorial in The Journal of Accountancy stressed that the earnings per share figure did not necessarily correspond with market value. The market value might be correlated with earnings per share in an ideal situation but that situation was unlikely to occur. The editor felt that for corporations which plowed back earnings rather than paying larger dividends the "principal per share" might be a much more important figure than earnings per share.[15]

The next time an earnings per share figure occurred in the annual reports of the United States Steel Corporation was 1949, when a two-year comparison was made. The dropping of the earnings per share figure was

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[14] Andreas S. Natvig, "Earnings Per Share," The Journal of Accountancy, 49 (April, 1930), 251.

[15] "Earnings Not an Accurate Index," The Journal of Accountancy, 49 (May, 1930), 324-5.

surprising in view of the facts that financial services supplied the figure in comparison with past results and that a leading financial text placed such a great stress on the comparison of earnings per share over the years. In their text, Security Analysis, Benjamin Graham and David Dodd included many examples of comparative earnings per share figures for periods ranging from two to ten years.[16]

There was a seven-year lag between the inclusion of the earnings per share figure in the annual reports and the listing of the figure in Poor's and Moody's Manual. The use of the average common shares outstanding by the United States Steel Corporation and the statement of that fact in the 1930 Annual Report were in line with a technical point raised by an accounting writer. It appeared that the editor of The Journal of Accountancy objected to the stress placed on the earnings per share figure. The dropping of the earnings per share figure for the next eighteen annual reports seemed to indicate that the management of the

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[16] Benjamin Graham and David L. Dodd, Security Analysis: Principles and Techniques (New York and London: McGraw-Hill Book Company, Inc., 1934), p. 18, p. 301, p. 302, p. 303, p. 304, p. 313, p. 315, p. 323, p. 376, p. 383, p. 390, p. 394, and p. 395.

United States Steel Corporation was not very responsive to the influences of these financial sources. It also might have been indicative of the United States Steel Corporation management's reluctance to portray a loss in the earnings per share figure, as the next few years witnessed losses from operations.

The United States Steel Corporation first included a schedule of its working capital figure in its 1933 Annual Report. A separate schedule showing current assets less current liabilities as of December 31, 1933, and of December 31, 1932, was presented on the fourth page of the annual report.

As early as 1916, Moody's had included a schedule of working capital for the United States Steel Corporation for the dates of December 31, 1914, and December 31, 1915.[17] William Lough illustrated the importance of working capital by devoting two chapters to it in his book on finance.[18] Five pages were devoted to the topic of

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[17] Moody's Manual of Railroads and Corporation Securities: 1916: Industrial and Public Utility Section, Vol. II (New York: Moody Manual Company, 1916), p. 3740.

[18] William H. Lough, Business Finance: A Practical Study of Financial Management in Private Business Concerns (New York: Ronald Press Company, 1920), p. 355 and p. 380.

working capital in the Accountants' Handbook.[19] H. S. Finney stated that the ratio of current assets to current liabilities was an indicator of the firm's solvency.[20]

As with the earnings per share issue, the working capital figure represented a topic whose entry into the annual reports of the United States Steel Corporation lagged considerably behind a financial service, Moody's. There also was a lag between the stress placed on this figure by a financial writer and two accounting writers and its eventual portrayal in the annual reports of the United States Steel Corporation.

Accepted Accounting Principles

Both the revision of past financial accounting methods to more acceptable methods and the treatment of current transactions according to accepted methods of accounting showed the continuation of the practice, discussed in the last chapter, of following established procedures of financial accounting. The accepted

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[19] Saliers, Accountants' Handbook, pp. 814-9.

[20] Finney, Principles of Accounting, Vol. I, Chapter 3, p. 17.

procedures of financial accounting that are discussed in this section are the treatment of capital and treasury stock, the arrearage on preferred stock, the reclassification of the premium on common stock, the breakdown of reserves, and the shrinkage in exchange conversion or usable value of assets of foreign subsidiary companies.

The Balance Sheet in the 1931 Annual Report contained further explanations of the two items of Capital Stock and Treasury Stock. The authorized and issued amounts of common and preferred shares were shown in parentheses next to each class of stock. A more descriptive title was given to the General and Reserve Fund Assets account of Securities held as investment for Contingent Reserves, including Common Stock the United States Steel Corporation held for account Employees' Stock Subscriptions. This was the first mention of treasury stock. The first inclusion of the par value of common and preferred stocks occurred in the Balance Sheet of the 1935 Annual Report. The number of shares of the United States Steel Corporation common stock held in the treasury was first disclosed in the 1932 Annual Report. The amount of the cost of the treasury shares was disclosed in the Balance Sheet of the 1933 Annual Report.

Montgomery held that the amount of issued, authorized, and treasury shares for each class of stock must be stated on the balance sheet.[21] The Federal Reserve Bulletin of 1917 on Uniform Accounting was quite specific on this matter. "On the balance sheet each class, if more than one, of stock must be stated, giving amount authorized, issued and in treasury, if any."[22] It was the more customary, but not the more strictly theoretical, approach to classify the treasury shares as an asset.[23] It appeared that the United States Steel Corporation moved toward the accepted way for handling these matters.

Because of the extreme depression conditions in 1932, the directors of the United States Steel Corporation declared a quarterly preferred dividend of 50 cents a share, rather than the full rate of $1.75 a share. The amount of the arrearage was clearly disclosed by the following statement in the "Dividends Declarations for

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[21] Montgomery, Auditing: Theory and Practice, 4th ed., p. 318.

[22] Robert H. Montgomery, Auditing: Theory and Practice, Vol. I (3rd ed.; New York: Ronald Press Company, 1921), p. 700, quoting Uniform Accounting.

[23] Dickinson, Accounting: Practice and Procedure, 2nd ed., p. 111.

Year" section of the 1932 Annual Report. Cumulative Dividend Arrearages on Preferred Stock to the Date of the Latest Payment amounted to 1 1/4 per cent or $4,503,513.75.

While this handling was not in complete accord with the treatment recommended by two leading accounting textbook writers, it did meet their disclosure requirements. Montgomery desired a balance sheet footnote for the arrearage, along with a statement in the preferred stock section that dividends have not been paid since . . .[24] Finney felt that the best way to disclose an arrearage was to segregate the arrearage from free surplus, if the total amount of the surplus account was greater than the amount of the arrearage.[25] By 1933, the arrearage appeared as a footnote in the Earned Surplus section of the Balance Sheet. The United States Steel Corporation's financial accounting was in tune with accepted accounting principles.

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[24] Montgomery, Auditing: Theory and Practice, 4th ed., p. 341.

[25] Finney, Principles of Accounting, Vol. I, Chapter 9, p. 15.

Until 1932, the Premium on Common Stock account had been included as a segment of the Reserves and Surplus section of the Balance Sheet of the United States Steel Corporation. This account was reclassified in 1932 as a segment of the Capital Stock section. This reclassification clearly segregated the Premium on Common Stock account from the Earned Surplus account. This segregation was in line with good accounting practice which required "[T]hat capital surplus at organization be clearly segregated and never be merged with surplus arising from operations."[26] Dewing stressed that the premium amount was to be treated as a part of capital stock.[27] Again the United States Steel Corporation appeared to have modified its financial accounting to acceptable accounting practices.

A schedule showing the four components of the General Contingent Miscellaneous Operating and Other Reserves was included in the 1934 Annual Report. In a letter to the Committee on Stock List, the American Institute of Accountants Special Committee on Co-operation

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[26] Montgomery, Auditing: Theory and Practice, 4th ed., p. 331.

[27] Dewing, Corporation Finance, p. 152.

with Stock Exchanges stated that all reserve accounts should be reported in detail.[28] The breakdown by the United States Steel Corporation was in line with the American Institute of Accountants position.

The United States Steel Corporation management's use of the Surplus Account for various charges and credits was continued in 1932 and $783,556.03 was written off because of the decrease in value of foreign currency. The write-off was in line with the practice of valuing foreign currency on hand and with foreign banks of exchange at the balance sheet date.[29]

A very significant revision occurred in the auditor's opinion paragraph in the Auditor's Report to Stockholders section of the 1933 Annual Report. The opinion paragraph in 1932 read thusly:

> We further certify that, in our opinion, the consolidated income account is a fair and correct statement of the results of operations of the United States Steel Corporation and its subsidiary companies for the year ending December 31, 1932.

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[28] American Institute of Accountants, Audits of Corporate Accounts, p. 13.

[29] Montgomery, Auditing: Theory and Practice, 4th ed., p. 101.

The opinion paragraph of the 1933 Annual Report appeared thusly:

> In our opinion, . . .the accompanying balance sheet and related income account and statement of surplus fairly present, in accordance with acceptable principles of accounting consistently maintained by the companies during the year under review, the position of United States Steel Corporation and subsidiary companies on December 31, 1933 and the combined results of operations for that year.

The New York Stock Exchange, through its Committee on Stock List, played an important role in the development of the revision of the auditor's opinion paragraph. In 1930, the New York Stock Exchange extended an invitation to the American Institute of Accountants to form a Committee on Co-operation with Stock Exchanges for the purpose of considering questions in which there was no consensus of opinion among accountants as to proper practice. On February 20, 1931, a change was made in the listing agreement so that any substantial change in depreciation percentages had to be reported to the Stock Exchange and attention had to be called to such a change in the next published report. On March 2, 1931, a conference was held with the American Institute of Accountants Special Committee on Co-operation with Stock Exchanges in regards to the scope of the auditor's

certificate. On January 12, 1932, a letter was sent to all listed corporations concerning the preference of the Committee on Stock List regarding certain accounting methods.[30]

In a letter to the Committee on Stock List on September 22, 1932, the American Institute of Accountants Special Committee stated:

> The more practicable alternative would be to leave every corporation free to choose its own methods of accounting within the very broad limits to which reference has been made, but require disclosure of the methods employed and consistency within application from year to year.[31]

On January 31, 1933, the president of the New York Stock Exchange sent a letter to the presidents of corporations listed on the Exchange concerning: (1) the scope of their audit, in regards to the Federal Reserve Bulletin of Verification of Financial Statements, (2) the audit status of subsidiaries, and (3) the issuance of essential information to auditors,

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[30]Committee on Stock Lists, "Historical Account of Relationship of New York Stock Exchange with Listed Companies as it affects Accountants," pp. 4-5.

[31]American Institute of Accountants, Audits of Corporate Accounts, p. 7.

> 4. Whether in their [auditors'] opinion the form of the balance sheet and of the income, or profit-and-loss, account is such as fairly to present the financial position and the results of operation.
>
> 5. Whether the accounts are in their opinion fairly determined on the basis of consistent application of the system of accounting regularly employed by the company.
>
> 6. Whether such system in their opinion conforms to accepted accounting practices, and particularly whether it is in any respect inconsistent with any of the principles set forth in the statement attached hereto.[32]

On October 24, 1933, the Committee on Stock List recommended to the Governing Committee of the New York Stock Exchange that the audit report of corporations be framed in a manner that would answer points 4, 5, and 6 of the president's letter of January 31, 1933. On October 25, 1933, the Governing Committee agreed. A standard report was drafted by the American Institute of Accountants Special Committee on December 21, 1933. The Committee on Stock List and the Controllers Institute of America agreed with it.[33]

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[32] *Ibid.*, pp. 15-6.

[33] *Ibid.*, pp. 21-30.

The auditor's opinion paragraph in the United States Steel Corporation's 1933 Annual Report reflected the opinion section of the standard audit report. The scope paragraph of the auditor's report in the 1933 Annual Report followed the wording of the scope paragraph of the standard audit report.[34]

Congress showed its concern about financial accounting by granting the Federal Trade Commission authority to prescribe financial accounting guidelines for the forms the Commission utilized in administering the Securities Act of 1933.

> . . .Among other things, the Commission shall have authority, for the purpose of this title, to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earning statement, and the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation or recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or

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[34] Ibid., pp. 30-1.

> desirable of consolidated balance sheets or income accounts directly or indirectly controlling or controlled by the issues, . . .[35]

An investigation of the securities exchanges was recommended by Senate Resolution 84 on May 4, 1932, and resulted in hearings commencing on May 23, 1933.[36] The letter of September 22, 1932, was presented as evidence before the Senate Committee by the Chairman of the Committee on Stock Lists on January 12, 1933.[37]

This matter was probably the best example of New York Stock Exchange initiative in the area of financial accounting and showed the reliance it placed on the American Institute of Accountants. Accounting texts were sources for accepted principles of accounting. The close relationships between the American Institute of

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[35] Securities Act of 1933, Statutes at Large XLVIII, Chapter 38, 85 (1934).

[36] U. S., Congress, Senate, Committee on Banking and Currency, Stock Exchange Practices, Hearings, before the Committee on Banking and Currency, Senate, on S. Res. 84, 72nd Cong., 1st sess., and S. Res. 56, 73rd Cong. 1st sess., 1933, Part 1, pp. 1-2.

[37] American Institute of Accountants, Audits of Corporate Accounts, p. 4.

Accountants and the New York Stock Exchange produced very meaningful adaptations in the United States Steel Corporation's financial accounting. A point might be raised that these adaptations were accomplished before the Federal Trade Commission (and later the Securities and Exchange Commission) was vitally concerned about financial accounting. Congressional interest in the stock exchanges provided an incentive for the New York Stock Exchange and the American Institute of Accountants.

Write-down of Contingent, Miscellaneous Operating and Other Reserves

The Contingent, Miscellaneous Operating and Other Reserves account had a balance of $58,650,318.30 at the end of 1930. A substantial write-down occurred in the next two years and the account balance at the end of 1932 was $38,920,657.44. The reduction of this account resulted in an alleviation of charges to the Income Account of $12,082,185.00 in 1931 and $7,647,475.74 in 1932. Since the net income for 1931 was $13,038,140.87 and the loss for 1932 was $71,175,794.60, the inclusion of the aforementioned charges would have made a substantial difference in the Income Account.

Finney stressed that this account should not be utilized to record any loss sustained during the period.

Such loss or losses were to be charged to the year of occurrence.[38] This was one of the few instances in which the management of the United States Steel Corporation utilized financial accounting to present a more favorable picture than actually existed.

Overhead Costs to the Income Account Rather than to Inventory

The depression conditions caused a significant modification of the financial accounting treatment of overhead expenses and taxes to inventory for the years from 1932 to 1935. A portion of these items appeared in the Income Account in this manner:

> Proportion of overhead expenses and taxes of the Lake Superior Iron Ore properties and Great Lakes Transportation service normally included in the value of the season's production of ore carried in Inventories, but which because of extreme curtailment in tonnage of ore mined and shipped in 1932 is not so applied, to wit:

Taxes	$11,436,772.85	
Depreciation	998,190.73	
Other Overhead Expenses	1,500,126.66	
		$13,935,090.24

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[38] Finney, Principles of Accounting, Vol. II, Chapter 45, p. 7.

The management of the United States Steel Corporation held that the inclusion of such cost would have increased the cost of production to an amount greater than its market value.

A considerable difference of opinion existed between two industrial accountants concerning the treatment of this matter. In April, 1933, an article in The American Accountant stressed the viewpoint that the unabsorbed overhead should be charged to inventory. In June, 1933, an article in the same publication stated that such overhead should be written off to the Profit and Loss Account. The writer of the April article felt that since standard cost and unabsorbed overhead were so closely allied, they should not be separated.[39] The writer of the June article was of the opinion that the cost accountant should adopt

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[39] R. J. Bernard, "New Haven Accountants Debate Disposition of Unabsorbed Overhead: Negative Side Wins on Proposition that Unabsorbed Overhead should be charged to Profit and Loss in the Year in which it is Incurred: Negative Argument by R. J. Bernard," The American Accountant, 18 (April, 1933), 113-4.

the viewpoint of a buyer and not include in the cost of inventory any amount not adding value to the product.[40]

The management of the United States Steel Corporation chose the alternative which was undoubtedly the least preferable in the years of the charge to the Income Account, because this method lowered net income in the years of the write-downs. This was an effective means of disclosing the low level of operations. The management of the United States Steel Corporation did not mislead its stockholders in the direction of overconfidence by its following of the alternative of charging such items to the Income Account.

Write-Down of Fixed Assets

In order to make a depreciation adjustment for past years, the United States Steel Corporation announced in the 1934 Annual Report that its subsidiaries were conducting a detailed analysis of their Property accounts. This study led in 1935 to the removal of the Appropriated Surplus

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[40] G. Preshaw, "Unabsorbed Overhead--Should it be Charged to Inventory?: An Analysis and Rebuttal of Arguments Favoring Absorption of Unabsorbed Manufacturing Expenses," The American Accountant, 18 (June, 1933), 179-80.

Invested in Capital Expenditures account of $270,000,000 from the Reserve and Surplus section of the Balance Sheet. The sum of $88,720,020.04 was credited to the depreciation reserves and $181,279,971.96 was credited to the Reserve for Amortization of Tangible Property Investment account, which was deducted from the Gross Fixed Property Investment account. The adjustment was held to be in line with the changing technology of the steel industry and the shifting markets of the nation. The modification of the remaining life of the fixed assets would partly offset the effect of the decreased base for depreciation on future yearly depreciation charges.

The write-down of the fixed assets of the United States Steel Corporation was achieved by increasing two reserve accounts and did not result in a direct credit to the Property account. The result was the same, as far as the effect on the book value of the Property account. A leading accounting practitioner and writer, George O. May, held that it was permissible to decrease the book value of fixed assets to their decreased fair value.[41] A

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[41] George O. May, "Influence of the Depression on the Practice of Accountancy," The Journal of Accountancy, 54 (November, 1932), 347.

vice-president of the American Appraisal Co., Inc., stated in an accounting publication that the 1932 price level was substantially below that of 1929 and property purchased between 1919 to 1929 was twice as costly as property purchased between 1900 and 1910. He held that another factor which necessitated readjustments was the requirements of new products and markets. The readjustment was to be the task of appraisers, industrial engineers, and accountants with the aid of statistical information.[42] The writers, Graham and Dodd, of a leading financial text decried the utilization by management of the practice of property write-downs to decrease future depreciation charges and, therefore, to increase income.[43]

It appeared that the write-down of the book value of the Property account was in tune with the recommendations of a leading accounting practitioner and writer and the method and reasons for the write-down were in line with the recommendations, stated in an accounting

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[42] L. H. Olson, "Reappraisals and Major Readjustments in Property Values," N.A.C.A. Bulletin, 13 (May 1, 1932), No. 17, Section I, 1157-9.

[43] Graham and Dodd, Security Analysis, pp. 418-9.

publication, of an appraiser. The statement of the United States Steel Corporation's management on the future yearly depreciation charges could be viewed as an answer to the point raised by Graham and Dodd.

Surplus Account Free of Adjustments

The Annual Report of 1933 marked the last year in which major use of the Surplus Account was made. A very minor adjustment of $118,523.13 for the surplus of controlled companies which had not previously been consolidated was the only Surplus Account adjustment for 1934. The 1935 Surplus Account contained just three captions: beginning balance, net deficit per Income Account, and ending balance.

The aforementioned controversy about the use of the surplus account for extraordinary items was still unsettled.[44] However, a rather sharp attack on the practice of including extraordinary items in the surplus account was published in an October, 1933, article in The Journal of Accountancy. W. G. Rowe held that the Surplus

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[44]Refer to the discussion on pages 94-100 in Chapter IV.

Account had become a dumping ground for items which should have appeared in the income statement. The only adjustments that might be entered in the surplus account should be the revision of the book value of assets and the establishment of special reserves for anticipated extraordinary losses. The income statement should be "all-inclusive" of items which affected it.[45] The American Accounting Association in its 1936 Statement on Accounting Principles held that:

> The income statement for any given period should reflect all revenues properly given accounting recognition and all costs written off during the period regardless of whether or not they are the results of operations in that period: to the end that for any period of years in the history of the enterprise the assembled income statements will express completely all gains and losses.[46]

A more specific, from the United States Steel Corporation's point of view, discussion on this matter was Richard N. Owens' article on the "Surplus Accounts of Iron and Steel Corporations." Owens concluded that:

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[45] W. G. Rowe, "Surplus Adjustment," The Journal of Accountancy, 56 (October, 1933), 291-3.

[46] "A Tentative Statement of Accounting Principles Affecting Corporate Reports," The Accounting Review, 11 (June, 1936), 189.

> The great variety of entries made in the surplus account of iron and steel corporation indicates that it is impossible for the stockholders to know what income his corporation is really earning unless he examines both the income statement and the reconciliation of surplus. . . .[47]

Graham and Dodd criticized the inconsistent financial accounting practice that the United States Steel Corporation followed when it included a $19,300,000 non-recurring gain for property sold in its Income Account for 1931, even though the non-recurring gains of the income tax refunds had been credited to the Surplus Account in the years just prior to 1931.[48]

The decision made by the management of the United States Steel Corporation to follow the "all-inclusive" concept of income reporting was made without any formal American Institute of Accountants or Securities and Exchange Commission promulgation. In the 1936 Annual Report, the Surplus Account was dropped as a formal statement and appeared as a part of the Comparative

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[47] Richard N. Owens, "Surplus Accounts of Iron and Steel Corporations," The Accounting Review, 11 (June, 1936), 178.

[48] Graham and Dodd, Security Analysis, p. 356.

Consolidated Statement of Income and Surplus. However, the opinions expressed in these two articles, the American Accounting Association, and the Graham and Dodd criticism, may have been factors in the decision process.

Major Revision of the Income Statement

The revised presentation of the 1936 Comparative Consolidated Statement of Income and Surplus (refer to Table 1 in the Appendix for this chapter.) followed the set-up of the income statement in Form 10-K of the Securities and Exchange Commission, Item 1A in Form 10-K was Gross Sales; item 2A was Cost of Goods Sold. Item 3 was Other Operating Expenses; items 4, 5, and 6 were respectively, Selling, General, and Administrative Expenses, Provision for Doubtful Accounts, and Other General Expenses. Item 7 through 10 dealt with Other Income. Items 11 and 12 were Losses on Securities and Miscellaneous Income Deductions. Item 13 was Interest and Debt Discount and Expenses. Item 14 was entitled Net Income before Provision for Federal Income and Excess Profits Taxes. Provision for Federal Income and Excess Profits Taxes was item 15. The

concluding item, 16, was Net Income or Loss.[49] It appeared that T. H. Sanders was correct (at least as far as the United States Steel Corporation was concerned) when he stated that the annual reports to stockholders would follow the Securities and Exchange Commission form although there was no formal compulsion to do so.[50]

Segregation and Write-Down of Intangibles

The Securities and Exchange Commission required that filing corporations include a detailed breakdown of the major types of intangible assets.[51] In the 1936 Annual Report of the United States Steel Corporation, a two-part presentation was made of the Properties Owned and Operated by Subsidiary Companies account in the Balance Sheet.

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[49] Haskins and Sells, Reprint of the Securities and Exchange Commission's "Instruction Book for Form 10-K for Corporations Annual Report," December 16, 1935 (New York: By Haskins and Sells, 1936), pp. 15-6.

[50] T. H. Sanders, "Influence of the Securities and Exchange Commission upon Accounting Principles," The Accounting Review, 11 (March, 1936), 73-4.

[51] Haskins and Sells, Reprint of the Securities and Exchange Commission's "Instruction Book for Form 10-K for Corporations Annual Report," p. 21.

These two parts were the tangible segment of $2,298,303,932.40 and the intangible segment of $260,368,521.53. The management of the United States Steel Corporation stated in the 1938 Annual Report that regulations stemming from the Federal Securities Act of 1934 necessitated this breakdown.

The write-down of the intangible segment to $1 was an integral part of the recapitalization plan of the United States Steel Corporation, which was to become a Delaware corporation with no-par, stated value of $75, common stock replacing the $100 par value common stock. The capital reorganization, discussed in the 1937 Annual Report, would add $217,581,300 to the Capital surplus account and reduce the Common Stock account by the same amount. A write-down of $260,368,521.53 of intangible assets to $1 was planned. The Capital Surplus account was to be reduced by the amount of the write-down. The explanation of the write-down in 1938 traced the origin of the amount of intangibles back to the aforementioned Bureau of Corporation study. A figure of $508,302,500 of the amount of intangibles in 1901 had already been written off; $260,368,521.53 remained on the books until the write-down. It was stated that the write-down in no way affected the value of the intangible assets.

The intangibles were, undoubtedly, of the nature of goodwill. Finney's definition of goodwill seemed to apply to this case. "Goodwill is the capitalized value of the profits of a business which are in excess of a normal or basic return on the capital exclusive of goodwill."[52] Accounting writers were not pressing for the write-off of goodwill. Finney held that just because many companies had misused the account in the past, this was no reason to write it off.[53] The "bad odor" associated with intangibles was because of the use of goodwill by enthusiastic financiers as recognized in the Accountants' Handbook, but this truth did not mean that an arbitrary write-off was dictated. The best policy was to amortize the goodwill over some estimated useful life.[54]

J. M. B. Hoxsey, the Executive Assistant to the Committee on Stock List of the New York Stock Exchange, urged that the write-down of intangible property should

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[52] Finney, Principles of Accounting, Vol. II, Chapter 41, p. 1.

[53] Ibid., Chapter 41, p. 12.

[54] William A. Paton, ed., Accountants' Handbook (2nd ed., New York: Ronald Press Company, 1934), p. 830.

not be made to the Capital Surplus account and should be made to the Earned Surplus account.[55] The American Institute of Accountants Special Committee listed as one of the six broad principles of accounting the principle that "Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fail to be made thereagainst. . ."[56] The first Accounting Series Release of the Securities and Exchange Commission dealt with a matter very similar to the United States Steel Corporation write-down. The Accounting Series Release was issued on April 1, 1937.

> To my mind the Chief Accountant of the Securities and Exchange Commission , the revaluation of the assets involved was simply a recognition by the company, as of the date of the write-down, of an accumulation of depreciation in values incidental to the risks involved in the ordinary operation of its business. This depreciation did not occur as of a given date; it took place gradually over a period of years coincident with the evolution of the industry. Thus it was an

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[55] J.M.B. Hoxsey, "Writing Down Assets and Writing Off Losses," The American Accountant, 18 (April, 1933), 104.

[56] American Institute of Accountants, Audits of Corporate Accounts, p. 11.

> element of production costs applicable to an indefinite period prior to the write-down and as such would have been charged against income had it been discerned and provided for currently.
>
> It is my conviction that capital surplus should under no circumstances be used to write off losses which, if currently recognized, would have been charged against income. . .[57]

The United States Steel Corporation's management segregated its fixed asset account into a tangible segment and an intangible segment because of a Securities and Exchange Commission regulation. The write-down of the intangibles to $1 was contrary to the views of two accounting writers; the charge to the Capital Surplus account was against the recommendations of the New York Stock Exchange, the American Institute of Accountants, and the Securities and Exchange Commission.

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[57] U. S., Securities and Exchange Commission, Accounting Series Releases: Releases 1 to 63, Inclusive (Washington, D. C.: Government Printing Office, 1948), p. 3.

Inclusion of the Review of Internal Control in the Scope of the Auditor's Report

The important words, "We have reviewed the system of internal control" entered the scope paragraph of the Auditors' Report section in the 1939 Annual Report. These words were taken from the suggested statement of the accountant's report of the Special Committee on Auditing Procedure of the American Institute of Accountants.[58] This committee was initiated by the American Institute of Accountants in December of 1938 in the light of current public discussion.[59] The public discussion undoubtedly referred to the McKesson & Robbins scandal, which became known to the public in December, 1938. The Securities and Exchange Commission ordered an investigation into the matter on December 28, 1938.[60] The seriousness of the

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[58] "Extensions of Auditing Procedure," The Journal of Accountancy, 68 (December, 1939), 385.

[59] "Extensions of Auditing Procedure," The Journal of Accountancy, 67 (June, 1939), 333.

[60] U. S., Securities and Exchange Commission, Fifth Annual Report of the Securities and Exchange Commission for the Fiscal Year Ended June 30, 1939 (Washington, D. C.: Government Printing Office, 1940), p. 119.

Securities and Exchange Commission interest in this matter was evident by the quotation of its commissioner to the effect that if the public accountants did not do the job of maintaining and improving the standards of accounting practice, the Securities and Exchange Commission would step in and utilize its statutory powers.[61] The New York Stock Exchange endorsed the American Institute of Accountants' new short form and stated that independent auditors would tighten their procedures in regards to inventory and accounts receivable.[62]

The auditors' scope paragraph in the 1939 Annual Report of the United States Steel Corporation reflected the American Institute of Accountants recommendation. The Securities and Exchange Commission's interest in this matter undoubtedly provided an incentive for the American Institute of Accountants to act on this matter.

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[61] Ibid., p. 121.

[62] New York Stock Exchange, "Report of Subcommittee on Independent Audits and Audit Procedure, Committee on Stock List," The Journal of Accountancy, 68 (October, 1939), 238-43.

Change in Format and Content of the Annual Report

Substantial changes occurred in the 1939 Annual Report. It appeared that a very determined attempt was made to make the report more appealing to the reader. A section entitled The Corporation and the Nation was established in which the corporations' social philosophy was explained and in which reference was made to the new presentation of the Annual Report as being an attempt to gain mutual understanding with the public. A new section on How the Corporation Earned its Living in 1939 was another example of this new reporting philosophy. It is included as Figure 1 in the Appendix for this chapter. It marked a simplification of financial accounting data. A schedule of How the Corporation has Earned its Living Since 1902 showed a year-by-year comparison of the major items in the income statement from 1902 to 1939. The corporation's Balance Sheet was presented in chart fashion and was greatly simplified in this special schedule shown as Figure 2 in the Appendix for this chapter.

The National Association of Manufacturers had compiled a study about the utilization of the annual report as a form for industry opinion. The key assumption of business had been that the significance of a business was

found in its profit and loss statement; the new key assumption was that the chief business function was the service it performed for the nation and its community.[63] One of the objectives was to "humanize" the annual report.[64]

> Facts must be given and compared in the light of existing conditions affecting management, workers, and stockholders. They must be prepared on the assumption that the average man or woman who works, who owns stock, who votes, has little, if any, idea as to the relationship between capital, labor, and taxes when stated in large figures.[65]

A vice-president of an advertising firm in an article in The Controller suggested that the annual report should be a part of the company's public relations. The report should have a physical appearance that would attract the reader. Simplified balance sheet and profit and loss terminology and omission of cents would make the

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[63] National Association of Manufacturers, Making the Annual Report Speak for Industry (New York and London: McGraw-Hill Book Company, Inc., 1938), ix.

[64] Ibid., p. 181.

[65] Ibid., p. 32.

figures easier to grasp. The use of charts and graphs would make for a more meaningful presentation.[66] Barron's, a weekly financial paper, conducted a survey of 300 leading corporations in order to determine the desirability of further clarifying financial statements and of improving public understanding of finance. The feeling reported was that the shareholders were getting a better break than at any other time since the turn of the century. Many corporate executives felt that greater clarity and simplification was still desirable.[67]

The National Association of Manufacturers, an advertising representative writing in an accounting publication, and a financial weekly all stressed the changing reporting philosophy needed for the times.

The management of the United States Steel Corporation also took a step to modernize its presentation of the formal Balance Sheet. The Balance Sheet of the

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[66] Wesley A. Gilman, "Suggests Making Annual Report a Public Relations Document," The Controller, 6 (May, 1938), 127.

[67] F. H. McConnell, "Lessons for Stockholders: Managements Favor Greater Clarity in Reports, but Differ on Methods," Barron's, (July 17, 1939), p. 8.

United States Steel Corporation was finally presented in the order of liquidity in 1939. The word "finally" was used because of the rather late date of the change of the balance sheet presentation from the order of reverse liquidity. The suggested balance sheet form of the 1917 Federal Reserve Bulletin on Uniform Accounting utilized the order of liquidity presentation for the standard balance sheet.[68] In his 1923 copyright edition, Finney held that there was an increasing tendency to utilize the order of liquidity presentation.[69] Montgomery felt that the balance sheet should be ideally set up in such a fashion that the assets were presented in the order of their availability and the liabilities in the order of their dates of discharge. While the balance sheet form was not sacred, the fact that the standard balance sheet forms established by the Federal Reserve Board and Banks, the American Bankers Association, the National Association of Creditmen, and individual banks required that current

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[68] Uniform Accounting, 432-3.

[69] Finney, Principles of Accounting, Vol. I, Chapter 3, pp. 103-5.

assets be listed first in the order of their availability should be governing.[70]

Summary Assessment

This period marked the beginning of formal institutional emphasis on the matter of accepted accounting principles. However, the institutional emphasis did not assume the character of formal institutional pronouncements on accepted accounting principles until 1936, when the American Accounting Association published its Tentative Statement of Accounting Principles. It was not until September of 1939 that the first Accounting Research Bulletin was issued by the American Institute of Accountants. This Bulletin dealt with the topic of generally accepted accounting principles.[71] The first Accounting Series Release of the Securities and Exchange Commission was issued on April 1, 1937, and dealt with the aforementioned issue of charging the write-down of fixed

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[70] Robert H. Montgomery, Auditing: Theory and Practice (5th ed.; New York: Ronald Press Company, 1934), pp. 103-5.

[71] American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletin: Final Edition, p. 135, pp. 7-10.

assets to the Capital Surplus account. It was on April 25, 1938, that Accounting Series Release No. 4 was issued. This Release dealt with the Securities and Exchange Commission administrative policy towards financial statements and included stress on accepted principles.

> In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the public opinions of its chief accountant.[72]

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[72] Accounting Series Releases: Releases 1 to 63, Inclusive, p. 3 and pp. 5-6.

The next two periods marked the very pronounced impact on financial accounting by the American Institute of Accountants and the Securities and Exchange Commission promulgations. It would be interesting to note if the New York Stock Exchange and the American Institute of Accountants pressure for the usage of accepted accounting principles had a considerable effect on American financial accounting. One possible test of this proposition would be the ascertainment of when the questionable financial practices of the companies noted by Ripley were changed to more accepted accounting principles. Considering the dates of the first pronouncements by the American Institute of Accountants and the Securities and Exchange Commission on accepted accounting principles, one would be hard-pressed to credit formal promulgations of these bodies for any considerable improvement in United States financial accounting for this period. It appeared that the relationship between the American Institute of Accountants and the New York Stock Exchange and the presence of accounting texts and articles played a much more important role in this period in the United States Steel Corporation's financial accounting than did formal pronouncements of the American Institute of Accountants and the Securities and Exchange Commission. This point might

be raised today in the discussion of whether formal pronouncements are the only way to achieve financial accounting goals.

Accounting forces impacted on almost every topic discussed in this chapter. An accounting writer defined the formula for earnings per share. The editor of The Journal of Accountancy questioned the stress placed on earnings per share. Accounting writers recognized the importance of the working capital figure. The American Institute of Accountants played a very important role in the development of the concept of accepted accounting principles. Accounting texts were available for guidance in this matter. Finney warned against the use of contingency reserves to hide current losses. The accounting treatment of overhead in inventory was a controversial matter, as can be seen by the difference of opinion between two industrial accountants. George O. May approved the write-down of fixed assets; an appraiser in an accounting publication established some ground rules for the write-downs. Two journal articles and the American Accounting Association 1936 Statement dealt with the issue of the use of the Surplus Account. Accounting writers opposed the arbitrary write-off of intangibles and the American Institute of Accountants stated that the write-off

of assets should not be charged to the Capital Surplus account. The American Institute of Accountants revised its standard audit report because of the McKesson & Robbins scandal. An advertising executive stated in an accounting publication that annual reports should be made more attractive for readers. Accounting writers called for the assets to be presented on the balance sheet in the order of liquidity.

Financial services and writers and the New York Stock Exchange were also quite active in financial accounting matters. Financial services had long portrayed earnings per share and the working capital figure. Financial writers also streseed these two items. Graham and Dodd in their finance text warned against the use of the write-down of fixed assets to show higher income in the future and the inconsistent use of the Surplus Account for extraordinary items. Barron's played a role in the urging of the clarification and the simplification of annual reports. The New York Stock Exchange was vitally concerned with the very important area of accepted accounting principles. The Executive Assistant to the Committee on Stock List stated that the Capital Surplus account should not be used for the write-down of assets. The New York Stock Exchange approved the 1939 American Institute of Accountants revision of the standard audit report.

Congress may have urged the development of accepted principles of accounting by its investigation into stock exchange practices and its founding of the Securities and Exchange Commission. The Securities and Exchange Commission promulgated standard statement forms for reports to it and called for segregation of intangible and tangible assets in these reports. The Securities and Exchange Commission recommended that the American Institute of Accountants revise its audit standards due to the McKesson & Robbins scandal.

The National Association of Manufacturers desired that management revise the form and content of annual reports. Various groups concerned with the granting of credit had long exerted influence on the make-up of the balance sheet.

The management of the United States Steel Corporation did modify its financial accounting towards accepted accounting principles and towards the Securities and Exchange Commission forms and regulations. However, to illustrate the fact that the United States Steel Corporation's management was not totally bound by the American Institute of Accountants, the New York Stock Exchange, the Securities and Exchange Commission, and accounting texts, the United States Steel Corporation

utilized its contingency reserves to absorb current losses, wrote down its intangibles to $1, and charged the write-down to its Capital Surplus account. While stockholder overconfidence may have been caused by the write-down of the contingency reserves to absorb current losses, the inclusion of a significant extraordinary gain in the Income Account, when past practice would have indicated a credit to the Surplus Account, and the lessening of future depreciation charges by the write-down of the book value of fixed assets, the management of the United States Steel Corporation did take financial accounting actions which had a tendency to dampen stockholder overconfidence. These actions were the write-down of the book value of fixed assets, the inclusion of unabsorbed overhead in the Income Account and the write-down of intangibles to $1. They resulted in a significantly lower total assets figure.

Overall, the financial accounting actions by the management of the United States Steel Corporation probably dampened the confidence of stockholders. The decision to follow the "all-inclusive" concept of income reporting was taken by the management of the United States Steel Corporation without any formal American Institute of Accountants or Securities and Exchange Commission promulgation. There was a considerable lag between

financial writers' and services' influence and the United States Steel Corporation management's adoption of the portrayals of earnings per share and working capital. There was also a lag on the issue of the order of balance sheet presentation between various credit institutions and accounting writers and the eventual adoption by the management of the United States Steel Corporation.

CHAPTER VI

WORLD WAR II AND ITS AFTERMATH
1940-1949

Historical Résumé and Synopsis of Financial Accounting Events

The economic impact of World War II on the United States started with the English and French purchases of war materials and was accentuated by our own defense program started in the middle of 1940. When the United States entered the war at the end of 1941, a full-scale economic mobilization occurred. The federal government sought to induce businesses to convert from peacetime to wartime production by a provision for a five-year amortization of emergency facilities constructed for the war effort. Plans for priorities and allocations were effectuated to ensure proper channeling and manpower for the war effort. The increased economic activity during

the wartime period resulted in national income of $183.8 billion in 1944, as compared to $72.5 billion in 1939.[1]

The price rise during the wartime period, measured by the average of wholesale prices of all commodities, increased from 77.1 in 1939 to 105.8 in 1945. By August of 1948, it reached 169.8 It declined to 154.4 in June of 1949. The post-war period witnessed organized labor making demands for higher wages because of freedom from wartime price and wage control, of the sustained high level of business, of the rising cost of living, and of the attraction of large profits.[2]

The Securities and Exchange Commission and the American Institute of Accountants had a very close working relationship, which evolved into a mutual policy of collaboration prior to the issuance of announcements and statements of accounting principles.[3] The American

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[1] Harold M. Somers, "The Performance of the American Economy since 1919," in Growth of American Economy, ed. by Harold F. Williamson (New York: Prentice-Hall, Inc., 1951), p. 917.

[2] Ibid., pp. 918-20.

[3] Ganson Purcell, "Cooperation between SEC and Public Accountants," The Journal of Accountancy, 76 (August, 1943), 155.

Institute of Accountants Research Bulletins were not mandatory. It was still stated in Accounting Research Bulletins that "the authority of the bulletins rests upon the general acceptability of opinions so reached."[4]

Financial accounting topics mentioned in this chapter include those of wartime reserves, the last-in, first-out (lifo) inventory method, the single-step form of the income statement, and the use of footnotes in the annual statements. Other events included are the net-of-taxes issue and the utilization of wartime reserves after the end of World War II. Other topics discussed are the term "surplus," replacement-cost depreciation, and accelerated depreciation.

Financial Accounting Events

Wartime Reserves

An expense account entitled Special Provision for Contingencies was charged for $25,000,000 in 1941; this amount was added to the Contingent, Miscellaneous Operating & Other Reserves account. The rationale offered for this

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[4] American Institute of Accountants, Depreciation and High Costs, Accounting Research Bulletin No. 33 (New York: American Institute of Accountants, 1947), p. 269.

addition to the reserve account was the high per cent of plant utilization made necessary by postponement of certain expenses until peacetime. The expense account title was changed to Estimated Additional Costs Applicable to this Period Arising Out of War in 1942 and there was established an account entitled For Estimated Additional Costs Arising Out of War in the Reserves section of the Balance Sheet for $50,000,000-$25,000,000 from 1942 and $25,000,000 from the reclassified 1941 entry. An additional charge of $25,000,000 was made for this purpose in both 1943 and 1944.

Rather immediate action was taken by the American Institute of Accountants on this matter. In Accounting Research Bulletin No. 13, issued in January of 1942, the Committee on Accounting Procedure of the American Institute of Accountants suggested that wartime reserves with an indeterminable amount be included as a deduction from current income. Accountants were urged to encourage the establishment of these wartime reserves. The Committee recommended that the government would be wise to give consideration to allowing such reserves as tax deductions. A list of eleven examples for which wartime reserves might

be established was included in the Appendix of Accounting Research Bulletin No. 13.[5]

As the reader will note later on in this section, the American Institute of Accountants adopted a point of view consistent with that of industry spokesmen. The American Institute of Accountants attempted to influence the government in regards to the issue of tax deductibility of wartime reserves. It is important to note again the promptness of the American Institute of Accountants' response. War broke out in December of 1941; the wartime reserve bulletin was issued in January of 1942.

The American Institute of Accountants' position was different from the American Accounting Association viewpoint on the matter of reserves. In the 1936 statement of Accounting Principles, the American Accounting Association Executive Committee held that "Income statements for a series of periods should not be distorted or artificially stabilized through the practice of creating large operating reserves in certain periods and charging to such reserves losses in succeeding periods

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[5] American Institute of Accountants, Accounting for Special Reserves Arising Out of the War, Accounting Research Bulletin No. 13 (New York: American Institute of Accountants, 1942), pp. 111-7.

which it is desired not to reflect in the current income statement."[6] However, illustrating the fact that academic accountants were divided on this matter, the accounting writers of A Statement of Accounting Principles stressed that business leaders felt that the accountants should show adequate reserves to cover all reasonable contingencies. Sanders, Hatfield, and Moore felt that this conservative accounting practice was commendable.[7] The American Institute of Accountants' position did have some academic basis, if one granted that status to the Sanders, Hatfield, and Moore monograph.

The Securities and Exchange Commission also gave approval to the financial accounting policy of wartime reserves. In Accounting Series Release No. 42, dated January 8, 1943, the Chief Accountant of the Securities and Exchange Commission urged that "[c]areful consideration must be given to the need for establishing appropriate reserves intended to provide for final settlement of war

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[6] American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements, p. 63.

[7] Sanders, Hatfield, and Moore, A Statement of Accounting Principles, pp. 13-7.

production contracts, for post-war readjustments, and for other possible losses or adjustments resulting from present conditions." The Release referred to Accounting Research Bulletin No. 13.[8] It appeared that the Securities and Exchange Commission followed the American Institute of Accountants quite closely in content on this matter. This clearly illustrated the close relationship between the American Institute of Accountants and the Securities and Exchange Commission on financial accounting matters.

A spokesman for industry argued strongly for the tax deductibility of wartime reserves. In the opinion of Roscoe Seybold, then Vice-President and Controller of Westinghouse, post-war prosperity and a high degree of employment depended on the tax deductibility of wartime reserves, in light of the high excess profits tax.[9] The American Institute of Accountants went even further than its reference to tax deductibility in Accounting Research Bulletin No. 13. Its Committee on Federal Taxation

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[8] U. S., Securities and Exchange Commission, Accounting Series Releases: Compilation of Releases 1 to 112 Inclusive, p. 56.

[9] Roscoe Seybold, "The Viewpoint of Industry," N.A.C.A. Bulletin, 25 (February 1, 1944), No. 11, Section I, 559.

submitted various tax recommendations to the House Ways and Means Committee. One of these recommendations was the deduction of war reserves.[10] The Treasury Department was adamant in its refusal to allow wartime reserves as a tax deduction. It was felt that the practicability of establishing the wartime reserves, even with a rough approximation of accuracy, was apparently not feasible.[11] It appeared that an industry spokesman was very interested in the tax-deductibility of the wartime reserves. The American Institute of Accountants was not only concerned about the financial accounting acceptance of wartime reserves but also their tax deductibility. It was probable that the financial accounting issue was, in part, a starting point for the argument of tax deductibility. This close relationship between the American Institute of

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[10]Troy G. Thurston, "Review of Recommendations for Revision of Internal Revenue Code," The Journal of Accountancy, 73 (June, 1942), 491.

[11]Carl S. Shoup, "The Allowance of Post-War Reserves for Tax Purposes," N.A.C.A. Bulletin, 25 (February 1, 1944), No. 11, Section I, 567-8.

Randolph E. Paul, "Taxation Problems of the Transition Period: 1. The Treasury's Viewpoint," in Financial and Taxation Problems of the Transition Period, Financial Management Series, Number 75 (New York: American Management Association, 1944), p. 18.

Accountants and industrial spokesmen will later be discussed in this chapter in the light of labor union opposition to various financial accounting matters. (Refer to page 170.) The Treasury Department refused to be swayed by the American Institute of Accountants and industry efforts.

The two financial authorities examined presented opposing viewpoints on the general topic of reserves. Graham and Dodd felt that this practice led to equalizing of earnings between prosperity and depression years and was too readily open to abuse.[12] Dewing felt that each period should bear the charge for the uncertain costs of the future.[13] These financial sources, like the two academic sources sampled, failed to indicate a generally accepted principle toward the matter of general reserves.

The United Steelworkers of America applied pressure to disallow wartime reserves as a financial accounting expense for the determination of net income. This pressure was witnessed in a National War Labor Board Case, in which

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[12] Benjamin Graham and David L. Dodd, Security Analysis: Principles and Techniques (2nd ed.; New York and London: McGraw-Hill Book Company, Inc., 1940), pp. 501-2.

[13] Arthur Stone Dewing, The Financial Policy of Corporations, Vol. I (5th ed.; New York: Ronald Press Company, 1941), p. 645.

the United Steelworkers argued that concealed profits should be distributed as wage payments to the steelworkers. One of the items which the United Steelworkers held represented concealed profits was the Provision for Miscellaneous Reserves. The steel companies argued that these reserves were necessary. The steel panel for the National War Labor Board held on September 14, 1944, that the reserves were regarded as sound and in tune with good accounting practice and, as such, were not concealed profits.[14] This was just one example of the United Steelworkers' inability to modify financial accounting. It appeared that the American Institute of Accountants' position as to the acceptability of the wartime reserves influenced the thinking of the Steel Panel in its decision on the matter of concealed profits.

The topic of wartime reserves illustrated the very rapid adjustment made by the Committee on Accounting Procedure of the American Institute of Accountants. This

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[14] Report of the Steel Panel: In RE: United States Steel Corporation, et al., and United Steelworkers of America, CIO, Case 111-6230D (14-1, et al.) (Mimeographed on September 14, 1944, by the Steel Panel of the National War Labor Board), pp. 110-21. Files of United Steelworkers of America in Pittsburgh, office of Research Director.

represented a significant departure from the happenings of World War I, in which apparently manufacturers did the adapting and the American Institute of Accountants followed. The Securities and Exchange Commission apparently followed the lead of the American Institute of Accountants on this issue. Conflicting views on the matter of general reserves were held by the American Accounting Association and by the Sanders, Hatfield, and Moore report. There were also conflicting views expressed by the financial writers Dewing and Graham and Dodd. An industry spokesman urged the allowance of wartime reserves as a tax deduction, This viewpoint was also urged on the Treasury Department by the American Institute of Accountants. The Treasury Department did not change its views. The United Steelworkers was unsuccessful in its claim that the wartime reserves represented concealed profits. The management of the United States Steel Corporation appeared quite willing to utilize this version of conservatism, even though a substantial lowering of net income resulted from this policy.

<u>Amortization of Emergency Facilities</u>

Another addition to the expenses listed in 1941 was the Amortization of Emergency Facilities for $9,948,140. In 1942, $31,962,146 was charged. In 1943, an amount of $43,652,882 was the expense for this item, and $56,765,012 was the 1944 expense amount. In 1945, $44,215,710 was the expense amount.

This topic was another example of quick adaptation of institutional forces to wartime conditions. The executive branch of the federal government and Congress initiated the second Revenue Act of 1940, which allowed the sixty-month amortization of emergency facilities for the war effort.[15] One of the purposes for which reserves could be established for wartime conditions, as promulgated in the aforementioned Accounting Research Bulletin No. 13, was the amortization of the cost of additional facilities which would have lost much of their economic usefulness at the end of the war.[16] The United Steelworkers held that

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[15] John D. Filson, "Amortization of Emergency Facilities," <u>The Journal of Accountancy</u>, 71 (February, 1941), 103-4.

[16] <u>Accounting Research Bulletin No. 13</u>, p. 116.

amortization was another example of concealed profits. In a brief submitted to the aforementioned Steel Panel of the National War Labor Board, the union held that almost one-half billion dollars was purchased by the steel industry under the five-year amortization provisions and that most of these facilities would be available for use after the war to enhance the profit position of the companies.[17] The Steelworkers claimed that one-half of the emergency amortization represented concealed profits in the steel industry.[18] The Steel Panel decided that the Union claim was unwarranted.[19] The United States Steel Corporation was again willing to report a lower income figure by following a faster write-off policy than probably the estimated useful lives of the emergency facilities called for.

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[17] National War Labor Board, Case No. 111-6230-D 14-1 et al.: In Re: United Steelworkers of America--United States Steelworkers of America to Panel of National War Labor Board (Mimeographed, Undated), p. 163. Files of United Steelworkers of America in Pittsburgh, office of Research Director.

[18] Report of the Steel Panel, p. 111.

[19] Ibid., p. 118.

Lifo

The United States Steel Corporation adopted the last-in, first-out (lifo) method of inventory costing in 1941. The change in the method of inventory costing for some inventory items resulted in a reduction of the inventory amount and in net profits before taxes of $15,000,000. The previous method of inventory costing was the average cost method. The auditors noted and approved this change in the Auditor's Report section of the 1941 Annual Report. The lifo method was extended to other materials in 1942 and lowered net profits before taxes by $1,500,000. In 1947, lifo was extended to other subsidiaries and to other inventory lines and reduced net profit before taxes by $10,000,000.

The emergence of the lifo inventory method for financial accounting purposes was an example of the close tie-in between industrial spokesmen desiring a tax benefit, accounting spokesmen, and the American Institute of Accountants. Congress eventually wrote into the tax laws a lifo provision.

In 1936, the American Institute of Accountants Special Committee on Inventories held that the lifo inventory method for the oil industry, as recommended by

the American Petroleum Institute, was an acceptable accounting principle for these companies.[20] In 1938, a leading accounting practitioner testified for the Copper and Brass Mill Products Association before Congress on the subject of the lifo inventory method. Maurice E. Peloubet stated that the United States Treasury Department, by refusing to allow the copper and brass manufactures to use the lifo inventory method, was taxing profits or losses which were not the result of actual transactions. Peloubet utilized the Sanders, Hatfield, and Moore study as support for the lifo method and referred to the fact that he had the support of nine of the most prominent United States public accounting firms.[21] Congress responded with a provision in the Revenue Act of 1938 which allowed taxpayers in the non-ferrous metals and the copper industries to adopt the lifo method.[22] It appeared that

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[20] American Institute of Accountants, "Valuation of Inventories," The Journal of Accountancy, 62 (August, 1936), 132.

[21] U. S., Congress, Senate, Committee on Finance, Revenue Act of 1938, Hearings, before the Committee on Finance, Senate, on H. R. 9682, 75th Cong., 3rd sess., 1938, pp. 143-5.

[22] Revenue Act of 1938, Statutes at Large, 52, 459 (1938).

practicing and academic accountants and the American Institute of Accountants had some success in aiding certain industries in receiving a tax benefit. The American Institute of Accountants Committee on Federal Taxation moved very quickly to have the lifo method extended to other industries.[23]

The Revenue Act of 1939 modified the lifo provision whereby companies which met the Commissioner of Internal Revenue's regulations and did not employ another inventory method for financial accounting purposes could utilize the lifo inventory method.[24] The higher prices caused by the outbreak of the war in Europe increased the probability of companies choosing the lifo method. It was held by George O. May that since the lifo method tended to flatten out earnings over the years, most accountants would find it meritorious for this purpose.[25]

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[23] "The Last-in, First-out Inventory Method," The Journal of Accountancy, 66 (November, 1938), 310.

[24] Revenue Act of 1939, Statutes at Large, 53, Part 2, 877 (1939).

[25] George O. May, "Valuation or Historical Cost: Some Recent Developments," The Journal of Accountancy, 69 (January, 1940), 16-7.

The Research Director of the United Steelworkers claimed that the institution of lifo during periods of rising prices was another instance of the use of financial accounting devices to level off the profits of corporations. He felt that both the unions and the public had come to distrust much of corporate figures.[26]

On this matter Congress had a very definite effect on financial accounting. In order to claim the tax benefit of the lifo inventory method, a corporation had to adopt a method that would result in a lower net income during times of rising prices. The management of the United States Steel Corporation apparently chose the tax benefit rather than the benefits of a higher income. It was fairly evident that Congress did not act on this accounting matter without urging from both industrial spokesmen and accountants. Once again, the American Institute of Accountants apparently was a willing industrial proponent. The union views that lifo was just one more accounting device to even out income and that most of the figures

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[26] Otis Brubaker, "Labor's Interest in Financial Information," (paper presented before the Michigan Accounting Conference, Ann Arbor, Michigan, October 23, 1948), p. 7. From the files of the United Steelworkers of America in Pittsburgh.

published by corporations were not trustworthy had perhaps some merit to them.

Single-Step Income Statement

The Consolidated Statement of Income for 1942 was presented in a single-step manner, in which the sales revenue and other income amounts were totaled as revenue and all the expenses were included in one listing. (See Table 1 in the Appendix for this chapter.) Items such as Interest and Other Costs on Long-Term Debt and Estimated Federal Taxes on Income were no longer treated as separate deductions.

During the World War I period the United States Steel Corporation had presented its income statement along the lines of an industry memorandum which attempted to justify costs and prices. (Refer to pages 89-94 .) It appeared that similar reasoning was present in 1942. The Accounting Advisory Branch of the War Production Board listed certain expense items which were not admissible for the computation of cost for the performances of a government contract. Some of the inadmissible items were provisions for contingency reserves, income and excess profits taxes, interest on invested or borrowed capital,

and commercial advertising and selling expenses.[27] In other words, the War Production Board was not considering every expense as being of the same classification.

A rebuttal to this viewpoint came from a leading accounting academician, William A. Paton.[28] Paton presented a single-step model, in which the caption Interest on Bonds was not included in the Expenses, Losses, and Taxes section of the income statement.[29] However, he also showed the single-step Income Statement of Nash-Kelvinator, which was similar to the form of the United States Steel Corporation's Income Statement and which included Interest Paid as an ordinary expense.[30] Paton included what appeared to be a plea on behalf of industry to government officials.

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[27] Accounting Advisory Branch of the War Production Board, "Explanation of Principles for Determination of Costs under Government Contracts," The Journal of Accountancy, 73 (June, 1942), 525.

[28] William A. Paton, "Adaptations of the Income Statement to Present Conditions," The Journal of Accountancy, 75 (January, 1943), 8-15.

[29] Ibid., 14.

[30] Ibid., 15.

> . . .But with total revenue dependent upon the compilation of applicable costs plus an agreed upon fee, as in cost-plus-fixed-fee contracts, the adoption of a narrow point of view and the treatment of particular charges as "inadmissible," may be well-nigh disastrous, particularly for concerns with almost no civilian business. It is to be hoped that government officials in dealing with concerns engaged in war production will realize the importance of maintaining revenue at a volume sufficient to cover all unavoidable charges for the enterprise as a whole through the fiscal period, and also a reasonable return on investment, even if not all such charges can be readily assigned to particular contracts by ordinary costing concepts and procedures.[31]

Paton also stressed that the high corporate taxes of the wartime period resulted in a commendation of the view that income and profits taxes were not a distribution of profit but were an expense like other taxes, such as property taxes, payroll taxes, and sales taxes. It was inappropriate to utilize the term "net income" to an amount which could be eight to ten times as great as the actual net corporate income.[32]

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[31] _Ibid._, 12.

[32] _Ibid._, 13.

The previous form of the United States Steel Corporation's Income Statement was along the lines suggested by the Securities and Exchange Commission. (Refer to pages 134-5.) The Securities and Exchange Commission in its first Regulation S-X, which dealt with the form and content of financial statements issued to it, stated that the financial statements issued to it "may be filed in such form and order and may use such generally accepted terminology, as will best indicate their significance and character in the light of the provision applicable thereto."[33] The Securities and Exchange Commission apparently was urging a flexible approach towards the form of reports issued to it. Such flexibility undoubtedly provided a freer climate for experimentation than would a standard Securities and Exchange Commission form. The change of the form of the Income Statement by the United States Steel Corporation

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[33] U. S., Securities and Exchange Commission, Regulation S-X under The Securities Act of 1933 and The Securities Exchange Act of 1934: Form and Content of Financial Statements (Washington, D. C.: Government Printing Office, 1940), p. 5.

was considered to have marked a trend to more innovative reporting of financial statements.[34] The United States Steel Corporation's management once again was willing to be a leader in financial accounting presentation.

Notes to Accounts

In the 1942 Annual Report a section entitled Notes to Accounts was included for the first time. This section was placed on the lower part of the two-page Balance Sheet. Explanations were given for the following items: (1) Renegotiation of Government Contracts, (2) Basis for Federal Tax Provisions, (3) Depreciation and Amortization, (4) Estimated Additional Costs Arising Out of War, (5) Inventories, (6) Fixed Asset Valuation, (7) Insurance Reserves, and (8) Basis of Consolidation. (Refer to Table 2 in the Appendix for this chapter.)

It appeared that three promulgations by the American Institute of Accountants had an influence on the wartime disclosure of the United States Steel Corporation.

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[34] Arnold W. Johnson, "Form, Function, and Interpretation of the Profit and Loss Statement," The Accounting Review, 18 (October, 1943), 340-7; and "The 'Single-Step' Form of Income Statement," The Journal of Accountancy, 78 (August, 1944), 89-90.

It was recommended in Accounting Research Bulletin No. 13 that the purpose and amount of wartime reserves be shown as clearly as possible on the financial statements.[35] It was stated in Accounting Research Bulletin No. 15 that a footnote on the possibility of the renegotiation of war contracts would accomplish the purpose of disclosure.[36] The Committee on Auditing Procedure of the American Institute of Accountants in December of 1942 recommended that footnotes to the financial statements be employed to indicate the provisional nature of such items as renegotiation of war contracts, wartime federal taxes, war damages, amortization of wartime facilities, and accelerated depreciation due to increased wartime usage.[37] The American Institute of Accountants undoubtedly was a strong institutional force in the movement for footnote disclosure.

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[35] Accounting Research Bulletin No. 13, p. 111.

[36] American Institute of Accountants, The Renegotiation of War Contracts, Accounting Research Bulletin No. 15 (New York: American Institute of Accountants, 1942), p. 123.

[37] American Institute of Accountants, "Disclosure of the Effect of Wartime Uncertainties on Financial Statements: Statement on Auditing Procedure No. 15," The Journal of Accountancy, 75 (February, 1943), 153-5.

The United States Steel Corporation had long included explanations as to its method of inventory valuation and of its basis for consolidation. (Refer to page 51 and page 37 respectively.) However, these explanations were never in the form of formal footnotes to the financial statements. The discussion of the fixed asset valuation was one that appeared and disappeared through the years. The United States Steel Corporation anticipated the Securities and Exchange Commission footnote requirements for inventory valuation and for the basis of consolidation.[38] However, the Securities and Exchange Commission Accounting Series Release No. 41, issued on December 22, 1942, may have been a factor in the presentation of explanatory footnotes in the financial statements. The Release discussed the conditions by which a corporation could file its annual report to fulfill the requirements of the financial statements required by Form 10-K.[39] The detail and the position of the footnotes in the United States Steel

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[38] U.S., Securities and Exchange Commission, Regulation S-X, p. 9 and p. 16.

[39] U.S., Securities and Exchange Commission, Accounting Series Releases: Compilation of Releases 1 to 112, Inclusive. pp. 54-5.

Corporation Annual Report may have been in response to this Release. Accounting Series Release No. 42, issued on January 8, 1943, stated that the S-X contained requirements for the full and accurate disclosure of wartime reserves for the final settlement of war production contracts, for post-war readjustments, and for other possible losses or adjustments resulting from present conditions. Rule 3-19(c) of the S-X required the disclosure of amortization policy.[40] By this Release, the Securities and Exchange Commission further adapted its disclosure requirements to wartime conditions. Undoubtedly, the Securities and Exchange Commission played an extremely important role in the concept of disclosure and probably was a prime factor in footnote disclosures in financial accounting by its example in this area.

Another important factor in the use of footnotes for financial statement may have been a publication by Roy A. Foulke, the Manager of Dun & Bradstreet's Specialized Report Department. In The Balance Sheet of the Future, Foulke reported on the results of questionnaires sent to

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[40] *Ibid.*, pp. 56-7.

1,500 bankers; 1,500 corporate financial executives; 1,500 mercantile credit men; and 1,500 accountants.[41] The first question dealt with the desire to have more detailed description of statement items given in the financial statements. Of the number replying, 876 of the bankers and 80 per cent of the mercantile credit men replied in the affirmative. This was another example of interest in the matter of disclosure in financial statements.

The management of the United States Steel Corporation was in tune with these institutional demands with an adequate disclosure, by means of footnotes, of these matters.

Wartime Reserves after the War

The Reserve for Estimated Additional Costs Arising Out of War attained its largest balance, $95,359,091, in 1944 and was reduced to a zero balance by 1953. Because the amounts of the reductions after 1944 were relatively small and a continuation of the policy adopted in 1945,

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[41] Roy A. Foulke, The Balance Sheet of the Future (New York: Dun & Bradstreet, Inc., 1941), pp. 10-1.

the entire disposition of this account is discussed in this chapter.

Amortization of Emergency Facilities Write-Off

The date of September 29, 1945, marked the end of the period for the amortization of emergency facilities. On that date the United States Steel Corporation had an unamortized amount of $113,688,733 for these emergency facilities; this amount was written off. Since this amount was a tax deduction, the federal income tax expense was reduced by $78,104,664. The amount of the net-of-tax-loss of $35,584,069 was charged to the Reserve for Estimated Additional Costs Arising Out of War. Two topics were involved in this matter. One was the matter of net-of-taxes; the second was the amortization.

The American Institute of Accountants Committee on Accounting Procedure apparently anticipated the problem and issued Accounting Research Bulletin No. 23, entitled Accounting for Income Taxes, December of 1944. The Committee noted that a particular problem area existed when tax-deductible amounts were charged to the wartime reserve accounts, which were built up by charges not tax-deductible. This type of transaction would have resulted in a situation in which a write-off of an asset to the

reserve account would result in a decrease in income tax expense, if allocation was not followed, and, therefore, would have increased net income. The Committee felt that not only would this event have been repugnant to common sense but also contrary to the root principle of allocation.[42]

The Committee, therefore, recommended that income taxes should be allocated as any other expense. When an item resulting in a material deduction for tax purposes was charged to a reserve account, the tax expense on the income statement should be increased by an amount equal to the tax reduction resulting from the transaction. Another recommendation was that the income tax provision could be included at the end of the income statement or classified as another expense.[43] The Securities and Exchange Commission apparently upheld the views stated by the American Institute of Accountants in this research

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[42] American Institute of Accountants, Accounting for Income Taxes, Accounting Research Bulletin No. 23 (New York: American Institute of Accountants, 1944), pp. 185-6.

[43] Ibid., pp. 183-4.

bulletin by Accounting Series Release No. 53, issued on November 16, 1945.[44]

The United States Steel Corporation's handling of the unamortized emergency facilities was in tune with this Research Bulletin. The American Institute of Accountants Committee on Accounting Procedure definitely anticipated the problem of the tax effect of post-war write-offs to reserves established during the war. The acceptability of the single-step income statement was probably strengthened by the American Institute of Accountants' endorsement of the optional ways of handling the income tax provision. The Securities and Exchange Commission again agreed with the American Institute of Accountants' position.

While the Accounting Research Bulletin No. 23 was anticipatory in nature, the American Institute of Accountants Committee on Accounting Procedure was not as prompt in the matter of the write-off of emergency facilities. The Research Director of the American Institute of Accountants published a statement of his views, which he believed to be in harmony with the majority

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[44]"SEC on Accounting for Income Taxes," <u>The Journal of Accountancy</u>, 81 (January, 1946), 1.

opinion of the Committee on Accounting Procedure, on the matter of accounting for emergency facilities having substantial continuing usefulness. The essence of the statement was that the cost of the emergency facilities should be matched against revenues flowing from such facilities. It was no longer considered conservative to understate assets when such understatement resulted in the overstatement of income in the future. He held that balance-sheet representations were not as useful as they could be if the fair amount of important facilities were not included as assets.[45]

The Research Director felt that while the uncertain conditions during the war justified the use of the 60-month amortization for financial accounting purposes, the end of that uncertainty called for an appraisal of the value of the emergency facilities. For facilities found to have no substantial usefulness, a write-off was dictated. The corporate officials would be responsible for the determination of the value and, if this amount were deemed

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[45]Carman G. Blough, "Accounting for Fully Amortized Emergency Facilities Having Substantial Continuing Usefulness," The Journal of Accountancy, 80 (December, 1945), 428.

material, adjustments in the accounting records were to be made.[46]

The United States Steel Corporation's write-off of the unamortized amount of the cost of emergency facilities was undoubtedly against the views of the American Institute of Accountants' Research Director and, by implication, the Committee on Accounting Procedure. No mention was made in the 1945 Annual Report of the worthlessness of the emergency facilities. The amount was written off, apparently, because the amortization period had ended. The write-off to the reserve took this charge from the 1945 Income Statement and relieved future periods from charges for depreciation. The United Steelworker's view that the rapid amortization of the emergency facilities and the creation of wartime reserves were a concealment of profits appeared to have had some merit. (Refer to pages 166 and 162-3.) Clearly, the management of the United States Steel Corporation was misleading the stockholders by this treatment which hid the "loss" in the wartime reserve and reduced depreciation charges in future years.

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[46] Ibid., 429-32.

The Committee on Accounting Procedure upheld the view of its Research Director on this matter by Accounting Research Bulletin No. 27, issued in November of 1946. The Committee stated that in material cases an adjustment of accumulated amortization or depreciation of the cost of the emergency facilities would provide more useful financial statements.[47] The lag of almost a year between the statement of its Research Director and the Committee pronouncement rendered the Bulletin meaningless for the United States Steel Corporation and for probably many other companies.

Charging of the Cost of the 1946 Strike to the Wartime Reserve

The amount of $29.2 million was charged to the wartime reserve account for the net-of-tax amount of the $46.0 million loss associated with the 1946 steel strike and $4.3 million of other war costs.

This charge for the strike loss to the wartime reserve occurred after the American Institute of Accountants Committee on Accounting Procedure had

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[47] American Institute of Accountants, Emergency Facilities, Accounting Research Bulletin No. 27 (New York: American Institute of Accountants, 1946), p. 226.

recommended that loss from strikes should be charged to the current year and not to the wartime reserve. This recommendation was included in Accounting Research Bulletin No. 26, issued in October of 1946. The Bulletin stressed that the only costs which should be charged to the wartime reserve for post-war activities were the expenses of getting productive and other facilities from wartime uses to peacetime operations and the stand-by expenses of that reconversion period.[48]

The management of the United States Steel Corporation took an accounting position here in direct contradiction with that of the American Institute of Accountants. No mention of this fact was found in the Auditor's Report. This action led to an overstated net income figure, which may have served to cause overconfidence among the stockholders.

The Securities and Exchange Commission took a very weak stand on this matter in Accounting Series Release No. 54, issued on March 30, 1946. The Release held that since there was little agreement as to what constituted a war

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[48]American Institute of Accountants, Accounting for the Use of Special War Reserves, Accounting Research Bulletin No. 26 (New York: American Institute of Accountants, 1946), pp. 216-7.

cost and what constituted a post-war operational cost, no rules would be adopted to differentiate between these two types of costs but special disclosures of those post-war costs charged to the wartime reserves were to be made.[49] Even though the Securities and Exchange Commission had made known to the American Institute of Accountants its fear that strike costs might be charged to wartime reserves, the Securities and Exchange Commission did not, giving practicality as a reason, object to the numerous instances in which this practice occurred in 1946. The Securities and Exchange Commission felt that this problem would be eliminated as many companies were reclassifying the wartime reserves to surplus.[50]

Higher Costs of Replacing Inventories Depleted during the War

There was a balance of $27,961,425 remaining in the Reserve for Estimated Additional Costs Arising Out of War

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[49] Accounting Series Releases: Releases 1 to 63, Inclusive, pp. 159-61.

[50] U. S., Securities and Exchange Commission, Thirteenth Annual Report of the Securities and Exchange Commission: Fiscal Year Ended June 30, 1947 (Washington, D. C.: Government Printing Office, 1948), p. 127.

account December 31, 1946. This amount was reduced to $7,096,110 by December 31, 1952. Over this seven-year period $20.9 million of cost of goods sold expense was not charged to the Income Statements but was charged to the wartime reserve to cover the higher costs of replacing inventories depleted during the war. In the 1953 Annual Report the remaining $7.1 million balance was transferred to accrued taxes.

It appeared that the feeling, expressed in Accounting Research Bulletin No. 26, that wartime reserves would have a relatively short life after the end of the war was not true as far as the United States Steel Corporation was concerned.[51] The United States Steel Corporation did not reclassify the wartime reserve to surplus. The Securities and Exchange Commission thought that this procedure would eliminate the problem. (See page 187.) The management of the United States Steel Corporation reported a higher net income figure for seven years by utilizing the wartime reserve account for this purpose and closed the balance of the account--with a

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[51] Accounting Research Bulletin No. 26, p. 217.

scant and confusing explanation--to the accrued taxes account.

Removal of the Term "Surplus" from the Balance Sheet

The account Capital Surplus was renamed Capital in Excess of Stated Amount and the account Earned Surplus was retitled Income Reinvested in Business in the 1945 Annual Report. This change in terminology probably reflected the desire of the American Institute of Accountants to discontinue the use of the term "surplus." The Committee on Accounting Procedure in Accounting Research Bulletin No. 12, issued in September of 1941, recommended the general discontinuance of the term "surplus," because of the fact that the public connoted the term with "value."[52] The lag between the American Institute of Accountants' recommendation and the adoption by the United States Steel Corporation was four years.

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[52] American Institute of Accountants, Report of Committee on Terminology, Accounting Research Bulletin No. 12 (New York: American Institute of Accountants, 1941), pp. 107-9.

Additional Depreciation to Cover the Increased Replacement-Cost of Fixed Assets

An additional amount of $26,300,000 was included as depreciation expense in 1947 for the covering of the increased replacement cost of the fixed assets. This amount was 30 per cent of the depreciation provision based on original cost and was held to be well short of the amount needed for replacement but as this procedure represented a new application of the principle of depreciation, the per cent was deemed appropriate. Price, Waterhouse & Company stated that this procedure was not in accordance with generally accepted accounting principles.

This topic undoubtedly engendered more institutional conflict, both within institutional groups and between institutional groups, than any other financial accounting topic of the period studied by this report. The topic had both practical and theoretical facets and, as such, was probably the most far-reaching topic--other than the valuation issue--discussed in this work.

Industry spokesmen were concerned about increasing the amount of depreciation because of the higher replacement cost of fixed assets for both financial accounting and tax purposes. George Terborgh of the

Machinery and Allied Products Institute summarized his organization's conclusions on this matter. Terborgh felt that the earnest attention both of business leaders and tax authorities should be focused on the problem of the under-depreciation of prewar-fixed assets. Capital investment, he wrote, should be recovered in real purchasing power and not simply dollars. In many cases management should incorporate an increased amount of depreciation into its cost and financial accounting. If this step was not taken, management should adopt a conservative dividend policy so that real capital would not be infringed upon.[53] There appeared to be a two-pronged attack on the tax authorities to allow an increased depreciation amount and on management either to adopt increased amounts of depreciation for financial accounting or to adopt a conservative dividend policy so as to keep real capital intact.

Enders M. Voorhees, chairman of the Finance Committee of the United States Steel Corporation, testified on this matter before the Joint Committee on the Economic

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[53] George Terborgh, Depreciation Policy and the Postwar Price Level (Chicago, Illinois: Machinery and Allied Products Institute, 1947), p. 22.

Report in 1948. Voorhees held that while revenue presented relatively little difficulty in the determination of profit, the calculation of cost did. The cost of wear and exhaustion of facilities was a controversial topic, according to Voorhees, because of the changing price level. The blind adherence to the historical-cost principle for depreciation lead to a gross under-depreciation which could erode the Nation's tools of production.[54] He testified that:

> In 1947, United States Steel recognized that its true wear and exhaustion cost was represented by a greater number of the current "small" dollars than the 87.7 million dollars based on prior expenditures of "bigger" dollars. It was found that it took at least 30 percent more of those 1947 "small" dollars to equal the "bigger" dollars of the past. Therefore, as fully disclosed and explained in its annual report, United States Steel recorded its wear and exhaustion cost as 30 percent more than 87.7 million dollars, or as $114,000,000. This was a step toward

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[54]U. S., Congress, Joint Committee on the Economic Report, Corporate Profits, Hearings, before the Joint Committee on the Economic Report, 79th Cong. 2nd sess., 1948, pp. 589-94.

> stating wear and exhaustion in an amount which will recover in current dollars of diminished buying power the same purchasing power as the original expenditure.[55]

Union officials disagreed with the contention of industry. Stanley H. Ruttenberg, Director of the Department of Education and Research of the CIO, stated that industrial spokesman were utilizing the under-depreciation argument to conceal profits.[56] Ruttenberg felt that the problem of increased replacement cost was to be solved by past procedure of equity financing.[57] Otis Brubaker, Director of Research of the United Steelworkers of America, held that replacement-cost depreciation greatly distorted the reporting of net income and that unions would not be fooled by such a maneuver.[58] These union spokesmen made timely comments on this topic and,

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[55] Ibid., p. 597.

[56] Ibid., p. 136.

[57] Ibid., p. 148.

[58] "Steelworkers Favor Depreciation on Cost: A Letter from Otis Brubaker," The Journal of Accountancy, 84 (December, 1947), 458.

apparently, understood the effect such replacement-cost depreciation would have on profits. Their opposition was vociferous but apparently unsuccessful.

Two economists held opposing views on the matter of replacement-cost depreciation. Sumner Slichter stated that most corporations, in effect, count the rise in the cost of replacing fixed assets as profits and pay a stiff tax because they do so. There was present a danger of corporations living off its own capital, in that higher wages, dividends or lower prices might absorb the funds needed to replace the fixed assets.[59] In a theoretical article, Leo T. Little concluded that replacement-cost depreciation has no special validity for the entrepreneur. It would not be the accountant but it would be the entrepreneur who would determine the accrued charge for depreciation.[60] If one agreed with Little's view, the theoretical economic basis for replacement-cost depreciation was not present.

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[59] Corporate Profits, Hearings, pp. 4-5.

[60] Leo T. Little, "Replacement Costs--An Economist's View," Accounting Research, 1 (November, 1948), 78.

The Securities and Exchange Commission apparently opposed the replacement-cost viewpoint adopted by the United States Steel Corporation in 1947. While it was reported in the 1948 Annual Report of the Securities and Exchange Commission that a study was to be made into this topic,[61] the management of the United States Steel Corporation stated in its 1948 Annual Report that the Securities and Exchange Commission did not consider replacement-cost depreciation a satisfactory accounting principle.[62]

The Securities and Exchange Commission did take an unofficial position opposing the use of the replacement-cost principle for statements filed with it. From the mentioning of this opposition in the 1948 Annual Report, one might well conclude the Securities and Exchange Commission had some weight in the eventual decision on

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[61]U. S., Securities and Exchange Commission, Fourteenth Annual Report of the Securities and Exchange Commission: Fiscal Year Ended June 30, 1948 (Washington, D. C.: Government Printing Office, 1949), p. 111.

[62]Mr. Elmer C. Koch of the Securities and Exchange Commission's Chief Accountant's Office stated in an interview with the writer that the Securities and Exchange Commission had insisted that the United States Steel Corporation file its statements with the Securities and Exchange Commission according to the historical-cost principle.

the United States Steel Corporation's handling of this problem.

The New York Stock Exchange probably asked the United States Steel Corporation to present its statements in accord with generally accepted accounting principles. The Department on Stock List checked the annual reports of listed companies to note any qualified opinions and would probably have notified the United States Steel Corporation about this fact.[63] The New York Stock Exchange apparently was more oriented to a watchdog role, rather than a creative one in this era.

The issue of replacement-cost accounting presented a dilemma for the accounting profession. In 1946 and 1947, such companies as Crane Company, DuPont, the United States Steel Corporation, and Libby-Owens-Ford had made adjustments to their depreciation amount due to the price-level change. The Director of Research of the American Institute of Accountants felt that there were only two alternatives present, if public confidence in accounting

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[63] Interview with Mr. William R. Satterfield in September of 1969. Mr. Satterfield is the Assistant Director of the Department of Stock List of the New York Stock Exchange and was employed by the Department on Stock List during the replacement-cost controversy.

was to be retained. They were either to develop appropriate criteria for the application of replacement-cost depreciation and consistently apply it to all cases or to refrain from this practice entirely.[64] In a special statement the Committee on Accounting Procedure of the American Institute of Accountants agreed that replacement-cost depreciation was not a satisfactory solution at that time, as there was the danger of impairing the significance of reported profits.[65] This view was upheld in Accounting Research Bulletin No. 33, issued in December of 1947.[66] The issuance of this Bulletin did not stop the United States Steel Corporation from making its presentation but it undoubtedly was an important factor in the qualified opinion rendered by Price, Waterhouse &

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[64] Carmen G. Blough, "Current Accounting Problems: Replacement and Excess Construction Cost," The Journal of Accountancy, 84 (October, 1947), 333-6.

[65] American Institute of Accountants, "Appropriation, Not Charges, Recommended to Cover Inflated Replacement Cost," The Journal of Accountancy, 84 (October, 1947), 289-90.

[66] American Institute of Accountants, Depreciation and High Costs, Accounting Research Bulletin No. 33, pp. 267-8.

Company. The management of the United States Steel Corporation risked unfavorable publicity and considerably lower corporate earnings on this issue.

The interest in this matter did not subside with the issuance of Accounting Research Bulletin No. 33. The American Institute of Accountants conducted a research study among 150 prominent business executives, economists, investment analysts, government officials, labor representatives, bankers, and financial experts. While a majority of those replying felt that corporate income figures were unsatisfactory with a discussion of the higher cost of replacing fixed assets, a majority also felt that no basic change should be made in the income statement. The breakdown of those replying in the affirmative for a change to replacement-cost accounting and of those who opposed such a change indicated the lack of unanimity in many of the groupings.

	Favor Change	Against Changes	No Opinion
Business Executives-Steel	2	7	1
Business Executives-Utility	1	5	1
Business Executives-Retail	1	6	0
Business Executives-Textile	0	2	0
Business Executives-Motion Picture	0	2	0
Business Executives-Auto	4	5	0
Business Executives-Oil	2	5	0
Business Executives-General	14	34	1
Insurance Executives	1	3	3
Bankers	1	16	5
Economists & Statisticians	6	4	3
Labor Representatives	0	1	1
Accounting Teachers	4	5	0
Lawyers	2	7	0
Government Officials	2	4	1
Controllers	1	5	0
Investment Trust Officers	2	2	0
Security Analysts	3	7	0[67]

If the proponents of price level depreciation[68] could have garnered more support, possibly a modification could have been attempted by the American Institute of Accountants, which did survey the feelings of interested parties.

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[67] American Institute of Accountants, "Accounting and Changing Price Levels: An Inquiry Addressed to Business Executives and Financial Experts as to the Desirability of a Change in Generally Accepted Accounting Methods which would give Greater Weight to Price Changes, Especially in figuring Depreciation Charges," New York, 1948, survey pp. 1-3 (Mimeographed).

[68] There was a tendency to use the term "price-level depreciation" as synonymous with "replacement-cost" depreciation.

The American Accounting Association in its 1948 Revision of "Accounting Concepts and Standards Underlying Corporate Financial Statements" also supported the American Institute of Accountants' position that appropriate accounting concepts and standards would have to be established before price-level accounting would be justified.[69]

The controversy about price-level depreciation was the most controversial financial accounting topic of the period studied in this work. This topic affected many different groupings and was controversial within most of these groupings. The United States Steel Corporation and the other companies who presented adjustments to historical-cost depreciation in their annual reports did force this matter into study and debate. If the American Institute of Accountants survey had noted majority support for the price-level procedure, an official departure from the historical-cost basis might have occurred. The United States Steel Corporation was willing to be a trail-blazer in 1947; whether trail-blazing in a financial

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[69]American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements and Supplements, p. 14.

accounting principle area is possible today is a question that should be faced by the accounting profession, now that apparently much stronger sanctions are available to the American Institute of Certified Public Accountants and the Securities and Exchange Commission. (Refer to pages 212-3.)

Accelerated Depreciation

The disagreement between public and private accountants on the issue of price-level depreciation, coupled with the positions taken by the American Institute of Accountants and the Securities and Exchange Commission, resulted in the United States Steel Corporation's discontinuance of the price-level adjustment for depreciation in 1948. However, the United States Steel Corporation decided to adopt a policy of accelerated depreciation, which added the amount of $55,335,444 to the depreciation expenses in 1948. If plant utilization was more than the long-term peacetime average of 70 per cent, 10 per cent of the cost of facilities acquired during the year would be the accelerated amount. Ten per cent would also be deducted in the following year, if the same or higher plant utilization occurred. If a lower per cent of utilization occurred in that year, the accelerated amount would be reduced by a pro-rata amount. If utilization

fell below 70 per cent, no accelerated amount would be taken in the second year. The management of the United States Steel Corporation felt that this depreciation policy would match a much higher depreciation cost to the first years of new facilities, when their economic usefulness was the greatest. The amount of depreciation taken over the years on these new facilities would not, however, exceed the cost of these facilities. The accelerated depreciation was not deductible for Federal income tax purposes. Price, Waterhouse & Company noted the charge of depreciation method in its Auditor's Report and approved it.

Such a depreciation method was deemed acceptable by the Securities and Exchange Commission, which held the accelerated depreciation to be in tune with Accounting Research Bulletin No. 33 and with British accounting practice.[70] The Securities and Exchange Commission's statement that Accounting Research Bulletin No. 33 approved such a procedure was apparently not in accord with the

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[70] U. S., Securities and Exchange Commission, Fifteenth Annual Report of the Securities and Exchange Commission: Fiscal Year Ended June 30, 1949 (Washington, D. C.: Government Printing Office, 1950), p. 179.

Bulletin, in which the following statement was made. "It has been suggested in some quarters that the problem be met by increasing depreciation charges against current income. The committee does not believe that this is a satisfactory solution at this time."[71] The Securities and Exchange Commission position was not consistent with its own stated reason in this case. The Securities and Exchange Commission appeared to have been stretching the position of Accounting Research Bulletin No. 33 possibly to avoid another conflict.

It was stated in an editorial in The Journal of Accountancy that the depreciation method chosen by the United States Steel Corporation in 1948 was somewhat in the same manner as the units-of-production depreciation concept, which was generally acceptable. However, the editorial stressed that there was some danger that in the desire to minimize profits companies may be using the principle of accelerated depreciation to make arbitrary and unobjective charges against income.[72]

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[71] American Institute of Accountants, Depreciation and High Costs, pp. 267-8.

[72] "Trend to Accelerated Depreciation," The Journal of Accountancy, 87 (April, 1949), 271.

The opinion that the accelerated depreciation method was somewhat in tune with the units-of-production method was questionable. In his 1946 edition of Principles of Accounting: Intermediate, Finney stated that the production method was a rate per unit of production. He also made the following statement which was in direct contradiction with the United States Steel Corporation's goal of utilizing the per cent of plant capacity as a means to measure obsolescence.

> If a fixed asset is subject to obsolescence, the production method appears to be an illogical procedure for establishing a reserve intended to provide for both phsyical deterioration and obsolescence, because obsolescence presumably accrues on a time basis rather than on the basis of units of output. During a period of small production, the credits to the reserve might be less than the amount which should be provided for obsolescence on the basis of the lapse of time, and this inadequacy might not be compensated for in periods of larger production.[73]

The writer of the editorial also appeared to be stretching the use of the units-of-production method, along with the United States Steel Corporation, Price,

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[73] H. A. Finney, Principles of Accounting: Intermediate (3rd ed.; New York: Prentice-Hall, Inc., 1946), p. 325.

Waterhouse & Company, and the Securities and Exchange Commission. The close relationship between the American Institute of Accountants, and the Securities and Exchange Commission was, undoubtedly, once again apparent. The willingness of Price, Waterhouse & Company to approve the United States Steel Corporation's accelerated depreciation method was another example of the auditing firm's tendency to follow management's lead. The management of the United States Steel Corporation was again willing to lower current income by choice.

However, a protest was raised by the Research Director of the United Steelworkers. Otis Brubaker, in a letter to the editor of The Journal of Accountancy, endorsed the warning that the accelerated depreciation policy might be used to understate current income. He felt the steel industry was already then utilizing this method to hide current profits. Brubaker pointed out that the steel industry achieved the same effect as price-level depreciation by the accelerated depreciation method. He raised the question of what would happen in the years of "sub-normal" use and concluded that the accelerated depreciation policy was just as arbitrary as the price-

level method of 1947.[74] It appeared that the management of the United States Steel Corporation once again did not heed the viewpoint of the United Steel Workers.

Summary Assessment

The American Institute of Accountants moved very promptly to adapt financial accounting to wartime conditions, by using Accounting Research Bulletins on wartime issues in financial accounting. The Securities and Exchange Commission supported the American Institute of Accountants by accepting the wartime Accounting Research Bulletins. Whereas in World War I, industry apparently took the lead in wartime financial accounting adaptations, World War II witnessed American Institute of Accountants leadership. This leadership probably was at the price of labor union distrust of financial accounting reporting.

The United States Steel Corporation treatment of post-war charges to the wartime reserves highlighted the

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[74] Otis Brubaker, "Accelerated Depreciation Plan Seems as Arbitrary as Prior Replacement Cost Policy," The Journal of Accountancy, 87 (June, 1949), A-10.

fact that the American Institute of Accountants Accounting Research Bulletins were not mandatory and, as such, deviations occurred. These deviations were not always noted by the United States Steel Corporation's public accounting firm. The eventual decision by the Accounting Principles Board of the American Institute of Certified Public Accountants (the successors of the Committee on Accounting Procedure and the American Institute of Accountants) to have all departures from Accounting Principles Board decisions noted in the auditor's report could probably be viewed as a reaction to this kind of occurrence. (Refer to pages 212-3.)

The willingness of a company to trail-blaze in a specific financial accounting matter at the present time might be less than at the time of the United States Steel Corporation's replacement-cost depreciation attempt of 1947, because of the apparently more rigid nature of Accounting Principles Board decisions. The presentation of the depreciation adjustment by the United States Steel Corporation and other companies in 1947 did raise much interest in the matter and, as such, probably compelled the American Institute of Accountants to act.

This period witnessed the ascendancy of the American Institute of Accountants on financial accounting

matters. The American Institute of Accountants was the focal point on the issues of wartime reserves, amortization of emergency facilities, lifo, footnotes to financial statements, the post-war use of wartime reserves, the use of the term "surplus," and the replacement-cost controversy. Undoubtedly, the American Institute of Accountants established itself as the leader of the accounting profession in this period through the Accounting Research Bulletins. The American Institute of Accountants at times mixed federal tax considerations with financial accounting issues. Whether such considerations were placed as being more important than financial accounting considerations would be conjecture.

The Securities and Exchange Commission appeared to have followed the American Institute of Accountants leadership during this period. The Securities and Exchange Commission was willing to allow filing corporations to establish their own form of statement presentation, as long as it met the Securities and Exchange Commission requirements and would accept the annual reports of the filing companies for 10-K purposes, if such reports generally complied with S-X regulations. The Securities and Exchange Commission did fight the replacement-cost concept but did accede to the accelerated depreciation

concept. The Treasury Department was not swayed by the arguments for the tax deductibility of wartime reserves, replacement-cost depreciation, and accelerated depreciation. The War Production Board also was not swayed by arguments for the inclusion of wartime reserves as a billable cost. The New York Stock Exchange was apparently content with being relatively passive in financial accounting matters. A financial service, Dun & Bradstreet, showed interest in further disclosure in reports. Labor unions opposed wartime reserves, amortization of emergency facilities, lifo, replacement-cost depreciation, and accelerated depreciation.

Economists showed interest in the issue of replacement-cost depreciation but held diverse views as to its merits. Industrial spokesmen were active in the attempt to have wartime reserves become tax deductible, in the lifo inventory approval by Congress, and the replacement-cost controversy. These spokesmen appeared at times to be more interested in tax benefits than financial accounting effects. Congress showed its concern about accounting by the amortization of emergency facilities, the lifo inventory method, and hearings on the topic of replacement-cost depreciation.

The management of the United States Steel Corporation chose financial accounting treatments which substantially lowered net income during the war period. Wartime reserves, amortization of emergency facilities and the lifo inventory method lowered net income. In 1945 and 1946, and continuing through 1953, the wartime reserve account was utilized in such a manner as to increase net income for the year. However, in 1947, by using the replacement-cost adjustment, and in 1948 and the years following, by the use of the accelerated depreciation method, net income was substantially reduced below what it would have been if the past depreciation policy had been kept. Only in the years 1945 and 1946 did the management of the United States Steel Corporation cause overconfidence among stockholders, by choosing a financial accounting method that increased income.

CHAPTER VII

THE CURRENT YEARS

1950-1969

Historical Résumé and Synopsis of Financial Accounting Events

The recovery of the economy from its decline in 1949 predated the outbreak of the Korean Conflict, which coincided with the economic expansion and inflation of the early 1950's.[1] This period was marked by increased emphasis by labor on such fringe benefits as pension plans.[2] The inflation of the early 1950's led to demands for accelerated methods of depreciation, which was a part

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[1]Harold G. Vatter, The U. S. Economy in the 1950's (New York: W. W. Norton & Company, Inc., 1963), pp. 66-76.

[2]Gilbert C. Fite and Jim E. Reese, An Economic History of the United States (2nd ed.; Boston and New York: Houghton Mifflin Company, 1965), p. 667.

of the 1954 Internal Revenue Code.[3] By the late 1950's and early 1960's the growth rate of the United States economy was 3 per cent annually, far below what many thought was the country's full potential.[4]

The American Institute of Accountants was renamed the American Institute of Certified Public Accountants on June 3, 1957.[5] The Committee on Accounting Procedure of the American Institute of Accountants was replaced by the Accounting Principles Board of the American Institute of Certified Public Accountants on September 1, 1959.[6] The American Institute of Certified Public Accountants took a step in 1965 towards achieving greater compliance with the opinions of the Accounting Principles Board and with applicable Accounting Research Bulletins by "requiring

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[3] Vatter, The U. S. Economy in the 1950's, p. 155.

[4] Fite and Reese, An Economic History of the United States, p. 661.

[5] "What's in a Name?" The Journal of Accountancy, 103 (June, 1957), 30.

[6] American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins: Final Edition, foreward.

that departures from accounting principles accepted in Board Opinions and Accounting Research Bulletins be disclosed in footnotes to financial statements or in independent auditors' reports when the effect on the financial statements is material."[7] The Securities and Exchange Commission also tightened its control over financial accounting by stating that if the annual statements accompanying a proxy solicitation are materially different from the annual statements filed with it,[8] a reconciliation must be made in the annual report.

Financial accounting topics mentioned in this chapter include the questions of pension cost, the cost of stock options, the amortization of emergency facilities, and accelerated depreciation. Other events discussed are the disclosure of pension fund statements, the 1958

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[7] American Institute of Certified Public Accountants, Status of Accounting Research Bulletins, Accounting Principles Board Opinion No. 6 (New York: American Institute of Certified Public Accountants, 1965), p. 37.

[8] "SEC Proposes New Rules on Proxy Solicitations," The Journal of Accountancy, 117 (January, 1964), 9. Also, Conference with Mr. Elmer C. Koch of the SEC on August 27, 1969. Louis H. Rappaport, SEC Accounting Practice and Procedures, 2nd ed., revised printing (New York: Ronald Press Company, 1966), 20.4.

modification of the United States Steel Corporation's pension costs, revised depreciation guidelines, and the investment credit. Also incorporated into the chapter are the topics of disclosure of long-term leases and the 1968 depreciation revision of the United States Steel Corporation.

Financial Accounting Events

Pension Cost Increase

A basic revision in the pension plan provision of the employment contract, signed November 11, 1949, by certain subsidiaries of the United States Steel Corporation and the United Steelworkers of America and ratified by the stockholders on February 27, 1950, caused a considerable increase in the pension costs for 1950. The increase in pension cost was portrayed as follows:

Pension Costs	1950	1949
Non-contributory part of Pension Plan		
Funding of current service	$ 56,273,653.	$3,465,039.
Funding of portion of past service cost	50,000,000	-
Contributory part of Pension Plan	2,707,552.	3,664,885.
	$108,981,205.	$7,129,924.

The matter of the increased pension cost touched on three accounting issues: (1) the basis of the recognition of the yearly expense; (2) the handling of the past service cost contribution; and (3) the disclosure of the past service cost unfunded amount.

A partner of Price, Waterhouse & Company discussed three different methods of handling pension cost. One method was the pay-as-you-go method, in which the employer payments to pensioners be deducted as an expense in the year of payment. A second method was to contribute to a trustee the present value of the expected future pension costs as each employee retired and to utilize this contribution as the yearly pension cost. Both of these methods were considered as failing to reflect the accrual nature of the pension plan. A third method equated the financial accounting amount with the funding of the past service cost over a given period and the funding of the current service accruals.[9]

The United States Steel Corporation's handling of this issue was in tune with the third view. A consulting

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[9] Percival F. Brundage, "Pension Plans from an Accountant's Point of View," The Journal of Accountancy, 89 (January, 1950), 11-2.

actuary for the United States Steel Corporation testified before a congressional committee that the normal cost of the plan was 4.79 per cent of payroll and this amount was contributed to the pension trustee. This amount was considered to be a proper accounting base to calculate the pension expense of the firm.[10] It appeared that the United States Steel Corporation adopted the accounting method which yielded the best matching of current service costs to the current years and resulted in a higher expense total than the other two alternatives. This practice was continued until the 1958 revision, which is discussed later in the chapter.

The United States Steel Corporation treated the past service cost contribution as a current expense in 1950. This amount was the approximate maximum amount permitted by tax regulations for past service costs as a tax deduction in one year, as reported in the 1958 Annual Report. Companies could deduct up to 10 per cent of the past

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[10] U. S., Congress, Joint Committee on the Economic Report, December 1949 Steel Price Increases, Hearings, before the Joint Committee on the Economic Report, 79th Cong., 2nd sess., 1950, pp. 25-6.

service cost in any one year.[11] The funding amount for past service cost in 1950 was $50 million and the unfunded amount was estimated to be $496 million. This policy was continued from 1951 to 1957 with yearly charges, respectively, of $37,000,000; $26,000,000; $36,000,000; $36,000,000; $36,000,000; $38,000,000; and $38,000,000. It appeared that the tax status of this item was crucial for its financial accounting handling for the United States Steel Corporation.

While the unfunded past service cost of $496 million had been noted in hearings previously mentioned,[12] the United States Steel Corporation did not note the unfunded amount in its annual report until 1952. Leading public accountants questioned the wisdom of footnoting a liability so uncertain in nature.[13] However, the

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[11] John B. Inglis, "Accounting for the Cost of the New Industrial Pension Plans," The Journal of Accountancy, 90 (July, 1950), 27.

[12] December 1949 Steel Price Increases, Hearings, p. 27.

[13] Brundage, "Pension Plans from an Accountant's Point of View," 13.

Securities and Exchange Commission held that the estimate of the unfunded past service cost be included as a footnote to the balance sheets.[14] The two accounting practitioners argued for non-disclosure of this amount, while the Securities and Exchange Commission required disclosure.

Stock Option Plans

While the stockholders approved a stock option incentive plan for key management employees on May 7, 1951, two stockholders instituted suits seeking to enjoin and restrain the plan. A total of 384,000 shares were offered to key employees but none were exercised at the end of 1951. No options were granted in 1952 and none of the 1951 options were exercised. The stockholder suits were dismissed in 1953, in which 393,700 more shares were optioned but in which no options were exercised. In 1954, 281,266 shares were purchased under the option plan. The stock option issue was marked by a reversal of the Committee on Accounting Procedure of the American Institute of Accountants on the handling of the accounting aspect of stock options, a reversal by the Securities and Exchange

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[14] U. S., Securities and Exchange Commission, Sixteenth Annual Report of the Securities and Exchange Commission: Fiscal Year Ended June 30, 1950 (Washington, D. C.: Government Printing Office, 1950), p. 157.

Commission to reflect the American Institute of Accountants' opinion, the failure of dissident stockholders to control corporate officials, and a rigid disclosure requirement by the Securities and Exchange Commission.

Accounting Research Bulletin No. 37, issued in November of 1948, held that an accounting entry be made on the date the option right became the property of the grantee for the excess of the fair market value of the stock at that day over the option price for the stock.[15] The Revenue Act of 1950 provided an incentive for management to accumulate personal wealth by the provision that restricted stock options be taxed at capital gain rates when the stock, received when the exercise was made, was sold. There would be no element of compensation at the time of the grant, if the stock option plan met the requirements of a restricted stock option.[16]

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[15] American Institute of Accountants, "Accounting for Compensation in the Form of Stock Options: Complete Text of Accounting Research Bulletin No. 37," _The Journal of Accountancy_, 87 (January, 1949), 39-40.

[16] James J. Mahon, Jr., "Corporate Tax Planning to Get Minimum Personal Tax Liability for Executives and Stockholders," _The Journal of Accountancy_, 92 (November, 1951), 583.

The Committee on Accounting Procedure of the American Institute of Accountants issued a Revised Research Bulletin No. 37 to reflect the tax treatment of a restricted stock option plan. The valuation date was changed to the date of the grant.[17] The American Institute of Accountants took a position which removed the financial accounting recording of additional compensation awarded to management, since the fair market value at the date of the grant would coincide quite closely with the option price, if a restricted plan was to ensue. The American Institute of Accountants' stand did remove knowledge of the amount of this additional computation from the stockholders and mirrored the tax accounting treatment of restricted stock options.

The Securities and Exchange Commission found that the change in the income tax law resulted in most option prices being substantially the same as the market price at the date of the grant. Court decisions and the Internal Revenue Code were held to recognize that stock option plans

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[17] American Institute of Accountants, "Research Bulletin (No. 37) on Stock Options Revised: Compensation Measured As of Date Granted: Complete Text of Revised Accounting Research Bulletin No. 37," The Journal of Accountancy, 95 (March, 1953), 312.

afforded benefits to participants. Because of these benefits the Securities and Exchange Commission required that statements filed with it reflect the accounting treatment promulgated in the original Accounting Research Bulletin No. 37. The Securities and Exchange Commission first held that the Revised Bulletin No. 37 was not acceptable for its statements and that the procedure followed in the first Bulletin No. 37 be followed. The Securities and Exchange Commission intended to issue a public release on this matter but, after further consideration, it decided not to prescribe any procedure for the recognition of the cost of stock options.[18] The Securities and Exchange Commission reversed its position, even after it had publicly stated that it would not accept the revised Bulletin No. 37. This appeared to be an indicator that the Securities and Exchange Commission was reluctant to oppose the American Institute of Accountants on this issue.

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[18] U. S., Securities and Exchange Commission, Nineteenth Annual Report of the Securities and Exchange Commission: Fiscal Year Ended June 30, 1953 (Washington, D. C.: Government Printing Office, 1954), pp. 107-8.

The stock option plan was considered to be an excellent vehicle to decrease stockholder voting rights. Stockholders had no idea of the eventual value of the plan to the executives. Since corporate management utilized proxies to urge the adoption of the plan, stockholders had little control over the plan.[19] It was reported in the 1953 Annual Report that the two plaintiffs agreed to dismiss their suits against the United States Steel Corporation, after a suit brought against Standard Oil Company of New Jersey by one of the United States Steel Corporation plaintiffs was dismissed by the New Jersey Supreme Court. In the Standard Oil case, the New Jersey Supreme Court held that it was the stockholder who had the burden of proving that no person of sound business judgment would have entertained the view that the consideration, furnished by the executives, was not in accord with the value of the options.[20] As in the valuation issue discussed in the second chapter, dissident

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[19]"Shareholder Attack Against Stock Options for Corporate Executives," <u>The Yale Law Journal</u>, 62 (December, 1952), 90.

[20]Eliasberg v. Standard Oil Company, 23 N. J. Super., 449 (1953).

stockholders had the difficult task of the burden of proof. (Refer to pages 42-43.) Without a detailed breakdown of the option plan and with an eventual expense figure for the difference between the fair market value of the stock at the date the option became the property right of the grantee and the option price, the stockholders would have even less of an opportunity to meet the burden of proof required to overturn a stock option plan.

A variance existed between the disclosure of the pension plan recommended by the American Institute of Accountants and by the Securities and Exchange Commission. The American Institute of Accountants wanted disclosure of the number of shares under option, the option price, and the number of shares as to which options were exercisable. The number of shares for which options were exercised were to be stated, along with their option prices.[21] The Securities and Exchange Commission required that information be given on the fair value of the options which became exercisable in that period and that the fair market value at the date of exercise of the options exercised

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[21]"Revised Accounting Research Bulletin No. 37," 313.

during the period be noted.[22] The Securities and Exchange Commission desired more disclosure than did the American Institute of Accountants. The United States Steel Corporation's disclosure was more along the lines of the American Institute of Accountants requirement.

Amortization of Emergency Facilities

It was stated in the Notes to Financial Statements section of the 1951 Annual Report that \$12.8 million of the depreciation expense amount represented the amortization of the cost of emergency facilities. The amount of this amortization was included in this section until the 1960 Annual Report. The amounts were \$46.2 million in 1952, \$105.1 million in 1953, \$142.8 million in 1954, \$147.7 million in 1955, \$140.2 million in 1956, \$115.8 million in 1957, \$157.2 million in 1958, and \$22.2 million in 1959. The amortization procedure was mentioned in 1960 and 1961 but the amount of the amortization was not included.

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[22] U. S., Securities and Exchange Commission, Regulation S-X under The Securities Act of 1933, The Securities Exchange Act of 1934, The Public Utility Holding Company Act of 1935, and The Investment Company Act of 1940: Form and Content of Financial Statements, as amended to and including November 3, 1953 (Washington, D. C.: Government Printing Office, 1954), p. 8.

The outbreak of the Korean Conflict revived the World War II taxation policy of the 60-month amortization of emergency facilities.[23] Once again, this method was chosen by the federal government to urge industry to meet wartime necessities. The Office of Defense Mobilization did not allow the amortization amount as a cost for contract pricing,[24] even though the American Institute of Accountants lobbied with the Secretary of Defense on this matter. The American Institute of Accountants Committee on National Defense felt that the five-year emergency period should be allowed as a cost for procurement purposes.[25] A Department of Defense Directive, issued in December of 1952, ruled that only "true" depreciation would be allowed as an element of cost for contract

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[23]Revenue Act of 1950, Statutes at Large, 64 Part I, Chapter 994, 939 (1952).

[24]"Accelerated Amortization Not Allowable as Cost in Pricing, DPA Official Says," The Journal of Accountancy, 92 (August, 1951), 139.

[25]"AIA Wires Wilson Favoring Allowance of Accelerated Amortization as a Cost," The Journal of Accountancy, 92 (July, 1951), 7.

pricing purposes.[26] The American Institute of Accountants once again reflected a viewpoint favorable to industry but it appeared that the Office of Defense Mobilization did not accept such reasoning.

The United States Steel Corporation utilized the amortization method allowed for tax purposes for financial accounting purposes. This was permissible, in terms of generally accepted accounting principles, by the wording of Accounting Research Bulletin No. 42. While it was stated in this Bulletin that financial accounting did not have to coincide with tax accounting, it was also stated that it might be easier to follow the tax accounting procedure for non-material items. Only when there was a material difference between the estimated depreciation amount and the amortization amount should the estimated depreciation amount be used.[27]

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[26]U. S., Department of Defense, "Department of Defense Directive, Subject: Treatment of Depreciation on Emergency Facilities Covered by Certificates of Necessity for Contract Pricing Purposes. . .Number 4105.34, 10 December, 1952," The Journal of Accountancy, 95 (February, 1953), 187.

[27]American Institute of Accountants, "Emergency Facilities: Accounting for Depreciation and Taxes Under Certificates of Necessity: Complete Text of Accounting Research Bulletin No. 42," The Journal of Accountancy, 95 (January, 1953), 48-50.

The United States Steel Corporation reported that the amortization procedure, because this method charged a greater amount of cost to the earlier years of the asset than would have been the case if a more extended depreciation period were used, was in tune with the accelerated depreciation method discussed in the last chapter. This was one more example of utilizing a financial accounting procedure which lowered income during the years of the write-off. Of course, the charge for depreciation in years after the first five years would have been lower. It appeared that the United States Steel Corporation was holding that the estimated useful lives of these assets were greater than five years or else the tie-in with accelerated depreciation would not have been made. Undoubtedly the wording of the Accounting Research Bulletin No. 42 allowed such a situation. Here tax accounting apparently did rule for financial accounting purposes in the United States Steel Corporation, and, to some extent, for the Committee on Accounting Procedure of the American Institute of Accountants.

<u>Accelerated Depreciation</u>

A section of the 1954 Annual Report was devoted to the inadequacies of the two then new methods of depreciation, the double-declining balance method and the sum-of-the-years-digits method, in providing a proper depreciation amount for companies which required relatively large amounts of capital invested in costly and long-term facilities. It was not until 1958 that the declining-balance method of depreciation was adopted by the United States Steel Corporation for certain fixed assets. This switch may have been in response to the diminishing amount of depreciation under the five-year amortization method, which yielded \$57 million in 1958 compared to \$116 million in 1957. This issue of accelerated depreciation had similarities to other accounting topics since the beginning of World War II. Industry spokesmen and the American Institute of Accountants arguing for a tax benefit and labor union officials arguing against it. Congress responded in favor of industry and the United States Steel Corporation eventually adopted the tax method as its financial accounting method, considered by the American Institute of Accountants as being within the fold of generally accepted accounting principles. This method

lowered net income in the first years of adoption, at least.

The hearings before the Committee on Ways and Means on the general revision of the Internal Revenue Code was a prime testing ground for parties interested in accelerated depreciation. George Terborgh of the Machinery and Allied Products Institute held that the benefits derived from capital assets became less valuable as these capital assets aged. The double-declining balance method of depreciation, by charging approximately two-thirds of the asset cost in the first half of its useful life, was considered to conform closely to this reduction in value.[28] The American Institute of Accountants issued a statement which urged the Committee to adopt, if the Bureau of Internal Revenue did not loosen its requirement on depreciation, a more liberal attitude by allowing taxpayers more freedom in choosing methods of depreciation.[29] The statement of the American Federation

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[28] U. S., Congress, House, Committee on Ways and Means, Forty Topics Pertaining to the General Revision of the Internal Revenue Code, Part I (Topics 1-19), Hearings, before the Committee on Ways and Means, House of Representatives, 83rd Cong., 1st sess., 1953, pp. 747-51.

[29] Ibid., pp. 776-7.

of Labor opposed any tax reduction to business through amendments in depreciation methods because of reasons of equity.[30] The Internal Revenue Code of 1954 included as permissible the double-declining balance method of depreciation.[31] Congress appeared to have heeded industry and the American Institute of Accountants on this matter and apparently disregarded union opposition.

It did not take long for the tax accounting method of double-declining balance to be adopted by the Committee on Accounting Procedure of the American Institute of Accountants as a generally accepted principle of accounting. The declining-balance method and the sum-of-the-years digits method were held to be systematic and rational by Accounting Research Bulletin No. 44.[32]

George Meany, the president of the AFL-CIO, claimed that corporate profits were understated by $3 to $4

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[30] *Ibid.*, p. 772.

[31] *Internal Revenue Code of 1954, Statutes at Large*, 68A, 51 (1954).

[32] American Institute of Accountants, "Declining-Balance Depreciation: Accounting Research Bulletin No. 44," *The Journal of Accountancy*, 98 (December, 1954), 757.

billion because of accelerated depreciation.[33] It appeared that the United States Steel Corporation was not influenced by this statement because it adopted the double-declining balance method in 1958. Once again, the management of the United States Steel Corporation was willing to lower net income by adopting an accounting method which resulted in a higher expense in the current years.

Statement of Combined Pension Trusts

A statement of pension fund assets and a statement of changes during the year were included in the 1955 Annual Report. These statements were certified by Price, Waterhouse & Company. A more detailed breakdown of the type of investments held was also included.

Both labor union and congressional pressures were present in this area. The CIO Standing Committee on Ethical Practices recommended that detailed financial reports and audits be made to the beneficiaries of trusts by trustees at least once a year. These reports should be

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[33] "Labor Claims Profits Understated," The Journal of Accountancy, 105 (February, 1958), 12.

certified.[34] The United Steelworkers of America adopted a policy statement which called for annual audits of pension fund statements by an independent auditing firm of certified public accountants.[35] A subcommittee of the Senate Committee on Labor and Public Welfare recommended that an annual report be filed under prescribed regulations for all pension plans which included 100 or more employees. The report would contain a detailed financial statement of the operations of the fund and be audited by a certified public accountant.[36] Both labor unions and a congressional committee stressed the desirability of certified annual reports of pension funds and their disclosure.

Not only did these parties call for disclosure but a manager of accounting research for an accounting firm

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[34] U. S., Congress, Senate, Committee on Labor and Public Welfare, Welfare and Pension Plans Investigation, Hearings, before a subcommittee of the Committee on Labor and Public Welfare, Senate, on S. Res. 40, 84th Cong., 1st sess., 1955, Part I, p. 23.

[35] *Ibid*., p. 131.

[36] U. S., Congress, Senate, Committee on Labor and Public Welfare, Welfare and Pension Plans Investigation, S. Rept. 1734, 84th Cong., 2nd sess., 1956, pp. 8-9.

stressed the important role professional accountants could play in the reporting of pension funds.[37] It appeared that a public accountant was also interested in the disclosure of relevant pension data. The United States Steel Corporation did adopt a fairly detailed disclosure of its pension fund assets and changes during the year. This was one issue in which union pressure on an accounting matter was not, at least, flaunted by Congress and by the United States Steel Corporation.

Pension Cost Controversy

A very significant reduction of pension cost was noted in the 1958 Annual Report. For the first time since 1950, there was no amount contributed for the funding of past service cost. In 1957, $38 million had been funded for this purpose. The Board of Directors of the United States Steel Corporation, because of the depressed business conditions of 1958 and reduced rate of steel operations, transferred $61 million of previous amounts contributed for past service cost funding to the amount needed to fund

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[37] Hester Ellen Erb, "The Accounting Challenge in Employer Welfare Funds," The Journal of Accountancy, 100 (August, 1955), 43.

the current service cost. The effect was that pension cost was $24.5 million in 1958, compared with $131.7 million in 1957. The auditors noted that if the same payment procedure had occurred in 1958 that did in 1957, net income before taxes would have been decreased by $97 million and net income after taxes decreased by $46.6 million. This was explained in the Independent Auditors' Report section. The statements were, however, held to be in conformity with generally accepted accounting principles.

The United States Steel Corporation's accounting procedure in this case was within the very broad opinion of the Committee on Accounting Procedures of the American Institute of Accountants on the accounting for pension costs. The Committee on Accounting Procedure in Accounting Research Bulletin No. 47 stated that it preferred the method which included as current cost the actuarial determination of the present cost of future benefits and allocated a portion of the past service cost to the current year. However, because of the lack of crystalization of one method to handle pension costs, it did not recommend that its preference be the only acceptable method.[38] The

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[38] American Institute of Accountants, "Accounting Research Bulletin Number 47: Accounting for Costs of Pension Plans," The Journal of Accountancy, 102 (October, 1956), 66.

unwillingness of the Committee on Accounting Procedures of the American Institute of Accountants to delimit its preferred method as the only acceptable one allowed practices such as the United States Steel Corporation's to go under the banner of generally accepted accounting principles.

The management of the United States Steel Corporation utilized the lack of uniformity in accounting for pension cost to increase net income after taxes in 1958 by $46.6 million. This represented a case of utilization of a discretionary accounting procedure to improve the net income figure and probably led to stockholder overconfidence.

1962 Tax Changes

Two taxation changes were discussed in the 1962 Annual Report. One of these was the new guideline procedure for depreciation and the other was the 7 per cent investment tax credit.

As was true in the case of accelerated depreciation in 1954, the Accounting Principles Board of the American Institute of Certified Public Accountants quickly approved the reduced guideline lives for financial accounting purposes by Accounting Principles Board Decision No. 1.

It was urged in this decision that the taxpayer review his estimated useful lives of fixed assets with the objective of making them conform to the reduced useful lives promulgated by the United States Treasury Department.[39] Once again, the American Institute of Certified Public Accountants was willing to adopt the rulings of tax accounting to apply for financial accounting and the management of the United States Steel Corporation was willing to lower reported income for the next few years, at least, by increasing the yearly charges for depreciation.

The United States Steel Corporation's accounting treatment of the 7 per cent investment credit resulted in a reduction of the federal tax expense and liability accounts in 1962 and 1963. The amount of the credit was also included as an addition to the yearly depreciation expense and credited to the accumulated depreciation account for these two years, because of the fact that this amount was not allowable for tax purposes.

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[39] American Institute of Certified Public Accountants, New Depreciation Guidelines, Accounting Principles Board Decision No. 1 (New York: American Institute of Certified Public Accountants, 1962), pp. 1-2.

The matter of the accounting treatment of the investment credit was marked by a split between the American Institute of Certified Public Accountants and the Securities and Exchange Commission. It was stated in Accounting Principles Board Decision No. 2 that the amount of the investment credit should not be used to reduce net income in the year of the purchase but should be carried forward as a deferred credit, which was to be amortized over the life of the asset. The controversy surrounding this decision was evident by the fact that this opinion received the support of only fourteen members of the twenty-one members of the Accounting Principles Board. Since it took a two-thirds majority of the members on the Board to issue an opinion, this opinion just passed.[40] However, the Securities and Exchange Commission ruled in Accounting Series Release No. 96 that it would accept either the American Institute of Certified Public Accountants' method or another method which would reduce the income tax expense amount by 48 per cent of the

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[40] American Institute of Certified Public Accountants, Accounting for the "Investment Credit," Accounting Principles Board Decision No. 2 (New York: American Institute of Certified Public Accountants, 1963), p. 7.

investment credit and establish a deferred credit for the remaining 52 per cent.[41] The Securities and Exchange Commission broke with the American Institute of Certified Public Accountants on this matter and asserted its prerogatives in financial accounting.

The United States Steel Corporation's handling of this matter appeared to be in line with the second Securities and Exchange Commission method of reducing the federal tax expense. However, the explanation by the United States Steel Corporation was not very clear. The reduction in the federal income tax expense increased net income but the United States Steel Corporation then added the reduction to the depreciation amount for the year so net income was apparently not affected.

The American Institute of Certified Public Accountants modified its opinion on the investment credit in March of 1964. The Accounting Principles Board noted the Securities and Exchange Commission position and the fact that a significant number of companies had decided to increase net income in the year the tax credit arose. The

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[41] U. S., Securities and Exchange Commission, Accounting Series Release: Compilation of Releases 1 to 112 Inclusive, p. 248.

Board stated that since the authority of its decisions relied upon their general acceptability and Opinion No. 2 had not attained this degree of acceptability, it was willing to accept as an alternative a method which reduced net income in the year of the credit. There were fifteen votes for the change, although eight of these members assented with qualifications. Five members dissented. The strongest dissent was voiced by Leonard Spacek of Arthur Anderson & Co. He felt that Opinion No. 4 illustrated "the accounting profession's complete failure in its responsibility to establish accounting principles that will provide reliable financial statements that are comparable among companies and industries, for use of the public in making personal investment decisions."[42] This matter probably marked the low point of the American Institute of Certified Public Accountants authority in financial accounting during the current era.

By 1964, the provision that the investment credit not be allowable for depreciation was amended to allow

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[42]American Institute of Certified Public Accountants, Accounting for the "Investment Credit," Accounting Principles Board Decision No. 4 (New York: American Institute of Certified Public Accountants, 1964), pp. 21-4.

the amount of the investment credit to be depreciated. The United States Steel Corporation modified its handling of this matter by reducing its tax liability and establishing a deferred investment credit amount, which was in accord with American Principles Board Opinion No. 2 and would amortize the investment credit over the life of the related fixed assets. This method would tend to lower net income in the next few years, at least.

Long-Term Leases Noted

In its 1963 Annual Report, the United States Steel Corporation footnoted long-term leases for the first time. The wording was "At December 31, 1963, the United States Steel Corporation had long-term charters and leases covering ore ships, office space, and other properties with minimum rentals aggregating approximately $40 million per year, the major portion of which terminates within ten years."

The American Institute of Accountants had urged in 1949 that disclosure be made in the financial statements of the annual rentals of such leases and that indication be made of the period for which the leases will be in

effect, when the long-term leases are material.[43] The Securities and Exchange Commission had also required that pertinent facts of material long-term leases be disclosed in the statements.[44] If the assumption that long-term leases were a material amount for the United States Steel Corporation before 1963 were made, it appeared that the United States Steel Corporation lagged considerably behind the American Institute of Accountants promulgation and the Securities and Exchange Commission requirement.

The topic of lease disclosure was revived in the early 1960's. It was urged in an article in The Jouranl of Accountancy that the present rules pertaining to leases be implemented.[45] A publication of the Financial Analysts Federation urged that additional information on long-term leases be given in the financial statements.[46]

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[43] American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins: Final Edition, p. 126 and p. 136.

[44] Louis H. Rappaport, SEC Accounting Practice and Procedure (New York: Ronald Press Company, 1956), p. 250.

[45] Alvin Zises, "Disclosure of Long-Term Leases," The Journal of Accountancy, 111 (February, 1961), 37.

[46] "Spotlight on Accounting," The Journal of Accountancy, 115 (February, 1963), 40.

The Director of Accounting Research for the American Institute of Certified Public Accountants concluded in 1962 that the disclosure of lease commitments had been inadequate and should be improved.[47] It appeared that renewed interest in this topic contributed to the climate of disclosure of long-term leases. The interest shown by the Financial Analysts Federation in financial accounting was noted in the publication of the Corporate Reporting for the Professional Investor. The utilization of an Accounting Research Study as a device to ascertain present practice and analyze its shortcomings marked another research effort of the American Institute of Certified Public Accountants.

Funding of Past Service Cost Resumed

The funding of past service cost was resumed in 1965 and became a part of the actuarial computation of the yearly contribution to the pension fund. The amount of unfunded liability as of December 31, 1964, was stated

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[47] John H. Myers, Reporting of Leases in Financial Statements, Accounting Research Study No. 4 (New York: American Institute of Certified Public Accountants, 1962), refer to the Director's Preface, xi, statement of Maurice Moonitz, Director of Accounting Research.

as being $207 million. The American Institute of Certified Public Accountants commenced publishing accounting research studies into various topics in accounting in 1961. These studies were to inform accountants about certain problem areas and were not to be conclusive.[48] One of these studies was entitled Accounting for the Cost of Pension Plans and its author recommended that past service cost should be taken into expense on a systematic basis over a reasonable period after the beginning of the pension plan.[49] The United States Steel Corporation again chose an accounting method which lowered net income and was in tune with a recommendation of an Accounting Research Study.

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[48] Maurice Moonitz, The Basic Postulates of Accounting, Accounting Research Study No. 1 (New York: American Institute of Certified Public Accountants, 1961), foreward.

[49] Ernest L. Hicks, Accounting for the Cost of Pension Plans, Accounting Research Study No. 8 (New York: American Institute of Certified Public Accountants, 1965), p. 5.

Revisions of Accounting Practices in 1968

With the explanations that a number of steel companies had switched from the double-declining blance method of depreciation to the straight-line method and that all major steel companies followed the flow-through method of handling the investment credit, in which method the investment credit is treated as a reduction in the federal income tax expense in the year of the credit, the United State Steel Corporation revised its accounting practices in these two areas in 1968. The United States Steel Corporation also revised the lives of certain of its properties. Net income was increased by $94.0 million over what it would have been if past accounting practices had been followed. These changes were approved by Price, Waterhouse & Company in its opinion.

The revision by the United States Steel Corporation of its depreciation method from the double-declining balance method to the straight-line method for financial accounting purposes but not for tax purposes was not an entirely unusual event in the years from 1956 to 1965. Fifty-five companies (including at least four iron and steel companies) revised their financial depreciation method back to the straight-line method. By

so doing, the median company, in terms of per cent of profit improvement, increased profit by 10.18 per cent. There was a range from 0 to 72.70 per cent profit improvement in these companies analysed.[50] The United States Steel Corporation improved its profit position by this revision. This occasion marked another instance in which the management of the United States Steel Corporation utilized a financial method which would increase net income in the year of adoption.

Since the United States Steel Corporation did not revise its depreciation method for taxation purposes, its taxable income and its operating income would differ by the amount of the difference in the two methods. The American Institute of Certified Public Accountants, through an Accounting Principles Board Opinion, had ruled that a deferred income tax account be established for the tax amount that would have been paid if financial and tax

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[50] T. Ross Archibald, "The Return to Straight-Line Depreciation: An Analysis of a Change in Accounting Method," in Empirical Research in Accounting: Selected Studies 1967 (Baltimore, Maryland: Institute of Professional Accounting, 1968), pp. 164-71.

accounting methods were the same.[51] This Opinion was passed with the minimum number of votes, 14, needed to issue an opinion of the Accounting Principles Board. The dissenters argued that tax allocation should only be made in those instances in which specific nonrecurring difference between taxable income and operating income led to a material misstatement of net income. They felt that the method favored by the Board would result in the carrying of a liability which was a mere contingency.[52]

The fears expressed about this contingent liability appeared justified by the dollar-amount of the deferred income tax account. The amount of the credit on December 31, 1968, was $240.2 million. By December 31, 1969, it was $261.1 million. This figure was comprised of $68.0 million from the investment credit account balance, which was reclassified as deferred income taxes, of $85.7 million from the 1968 tax difference between taxable income and operating income, and $86.5 million of

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[51] American Institute of Certified Public Accountants, <u>Accounting for Income Taxes</u>, Accounting Principles Board Opinion No. 11 (New York: American Institute of Certified Public Accountants, 1967), p. 158.

[52] <u>Ibid</u>., p. 181.

reclassified deferred taxes on income accrued in prior years. The total of this account was material in the light that the retained earnings amount, as of the balance sheet date, amounted to $1,720 million. Whether the Accounting Principles Board of the American Institute of Certified Public Accountants should insist on this controversial method with such a material effect on the income statement and on the balance sheet is a difficult one to answer. The management of the United States Steel Corporation, in effect, reclassified $154.5 million of deferred income taxes, which must have been present in past balance sheets but not disclosed. Since the only repository for this amount would have been the current liability section, the current liability amount must have been overstated.

As already mentioned in the discussion of the investment credit (refer to pages 237-8), the Accounting Principles Board Opinion No. 4 allowed the use of the reduction of income tax expense by the amount of the investment credit. The United States Steel Corporation availed itself of this option in 1968 and increased its net income in 1968 by this choice.

A possible reason for this opinion might have been the interest shown by financial sources in uniformity in

accounting. An example of this interest was the May 15, 1967, article in Forbes entitled, "What Are Earnings? The Growing Credibility Gap."[53] Accounting Principles Board Decision No. 11 definitely narrowed the gap in the financial accounting area of deferred income taxes.

The overall effect of the revisions of accounting methods on net income was to increase net income from \$159.7 million to \$253.7 million, a per cent increase of 58 per cent. It was an illustration of how the management of a corporation can affect a material change in net income by a switch of accounting methods. These changes, although carefully explained, would probably lead to stockholder overconfidence. The decision to increase net income also led to the establishing of a deferred income tax account with a significant balance. Since the deferred income tax method resulted in a substantially lowered net income position in 1968 and in a very material deferred credit account balance, one could conclude that Accounting Principles Board Opinion No. 11

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[53] "What are Earnings? The Growing Credibility Gap," Forbes (May 15, 1967), 28-42.

was accepted at a substantial cost to the management of the United States Steel Corporation in terms of statement presentation.

Summary Assessment

Accountants and the American Institute of Certified Public Accountants were concerned about every topic discussed in this chapter. Two public accounting partners argued for the non-disclosure of the unfunded past service cost liability. The American Institute of Accountants followed tax handlings of past service costs of pensions, of amortization of emergency facilities, of stock options, of accelerated depreciation, and of revised guideline lives. The American Institute of Accountants lobbied for the allowance of emergency amortization as being a cost for defense contracting purposes and lobbied for accelerated depreciation. The Accounting Principles Board reversal of its position on the accounting treatment of the investment credit probably marked the low point of the American Institute of Certified Public Accountants power in this period. However, Accounting Principles Board Opinion No. 6 probably reversed this position, as witnessed by the deferred income tax decision. Accounting Research

Studies were factors in the disclosure of long-term leases and in the handling of the cost of pension plans.

The Securities and Exchange Commission continued its efforts for disclosure in the areas of pension costs, stock options, and long-term leases. The reversal of its stand on the stock option issue was an indication of its reluctance to disagree with the American Institute of Accountants. However, the Securities and Exchange Commission stand on the investment credit did lead to an Accounting Principles Board reversal and illustrated the authority the Securities and Exchange Commission could wield. This authority was further extended when the Securities and Exchange Commission ruled that annual reports should not be materially different from the reports filed with it.

The president of the AFL-CIO voiced the labor view against the effect of accelerated depreciation on income but no apparent action resulted from this statement. However, strong union pressure in the area of reporting of pension trust statements probably was effective. The Federation of Financial Analysts probably became a factor in financial accounting by the issue of _Corporate Reporting for the Professional Investor_. _Forbes_ issued a strong article in favor of uniformity.

Stockholders once again proved not to be a potent force in financial accounting matters, as witnessed by the stock option controversy. Congress expressed a strong interest in pension trust reporting.

The management of the United States Steel Corporation again generally chose accounting methods which lowered net income in the accounting period. The expensing of past service costs, the use of the actuarial technique in pension costing, and the use of various tax depreciation methods lowered net income in the current year and in the next few years, at least. Exceptions were the 1958 pension cost issue and the 1966 depreciation and investment credit revision.

The effects of federal tax laws and regulations on financial accounting were noted in this period. The revised stock option provision in the Revenue Act of 1950 probably spurred the revised American Institute of Accountants' treatment of stock options. Three depreciation revisions--amortization of emergency facilities, accelerated depreciation, and revised guideline lives--became accepted financial accounting methods. The minimum financial accounting period for the amortization of past service cost followed the tax law.

The ability of management to revise its accounting methods so as to increase net income was shown in the 1958 pension cost revision and in the 1968 depreciation and investment credit revisions. Despite the Securities and Exchange Commission and the American Institute of Certified Public Accountants tightening restrictions on financial accounting, it should be noted that corporate management still has some control over their published statements.

The Accounting Principles Board promulgation as to deferred income taxes represented perhaps as strong a stand as ever taken by the American Institute of Certified Public Accountants on a controversial accounting matter. Since Accounting Principles Board rulings now have more authority behind them than before, the Board has then a greater responsibility to society for the effect of its opinions. The material amount of the deferred tax liability on the United States Steel Corporation's financial statements indicated that this accounting treatment will have a substantial effect on annual reporting. The Accounting Principles Board cannot escape the consequences of this decision if society concluded that this accounting treatment was not realistic.

CHAPTER VIII

SUMMARY AND CONCLUSIONS

The writer has already traced and assessed tentatively on a chapter by chapter basis the forces which have influenced the development of financial accounting in the United States from 1902 to 1969, utilizing the annual reports of the United States Steel Corporation as reference points. He now groups these assessments into two categories for further discussion. The first category is concerned with the forces influencing the financial statements of the United States Steel Corporation; the second category deals with implications drawn from the study for present-day financial accounting. In the Chapter Appendix the writer has listed the financial accounting conclusions discussed in this chapter and has referenced the listing in such a manner that the reader can quickly locate any evidence he wishes to examine in order to substantiate the conclusion.

Forces Influencing the Financial Statements of the United States Steel Corporation

Management of the United States Steel Corporation

The management of the United States Steel Corporation has been a major force in its financial accounting from the first full-year annual report in 1902 to the annual report of 1969. The 1902 statement illustrated the broad disclosure policy of the United States Steel Corporation and management's insistence upon crediting the working capital contribution to a surplus account. The management of the United States Steel Corporation was quick to adapt to World War I conditions and apparently utilized its income statements for 1917 and 1918 as justification for its wartime pricing. The utilization of the Undivided Surplus Account in the late 1920's illustrated management's freedom. The 1958 pension cost handling and the 1968 depreciation and investment credit revisions illustrated the discretion which the management of the United States Steel Corporation has in

financial accounting. However, the discretion to revise its depreciation expense for financial accounting was partly offset by the Accounting Principles Board ruling on deferred income taxes. While management always had financial accounting options available to it (and the earlier years witnessed a great degree of discretion), complete freedom was probably never there and now a much more limited amount of freedom exists.

If one concludes that the management of the United States Steel Corporation has always had some degree of discretion in financial accounting presentations, the question of how management has used its financial accounting options could be raised. The writer will, in order to answer this question, now review the various events in which management utilized this discretion.

The first annual report contained an example of conservatism, the inclusion of the bond sinking fund as a deduction in the Income Account. It appeared that, compared to other corporations, the total assets of the United States Steel Corporation were only moderately overvalued. The period from 1903 witnessed a continuation of conservatism in the removal of intercompany profits in inventory, in the recognition of only moderate profits for construction in progress, and in normalizing income

and/or dewatering the original overvaluation. Wartime financial accounting resulted in much lower net income and total assets during World War I but in higher income figuresafter the War. The utilization of the Surplus Account in the late 1920's and early 1930's must have been greatly confusing to stockholders. While the United States Steel Corporation utilized its contingency reserve account for current expenses in the early 1930's, its management utilized an inventory method which lowered net income by a substantial amount. The write-down of intangible assets to $1 greatly reduced future depreciation charges, and, therefore, led to higher net income in subsequent periods.

Wartime accounting practices lowered net income from 1941 to 1945, but these practices increased net income in the years immediately subsequent to World War II. Lifo and the accelerated depreciation method both lowered net income in the current year and probably for a long time into the future. The attempt at replacement-cost depreciation materially lowered net income and total assets. The depreciation items of amortization of emergency facilities during the Korean Conflict, the double-declining balance method of depreciation, and the revised guideline lives all resulted in a lower net income in current years and probably in future years,

assuming a constant yearly expenditure for fixed assets. However, the 1958 pension cost handling and the 1968 depreciation and investment credit revisions did materially increase net income.

The writer is of the opinion that it is clear that one could not issue a blanket indictment of the management of the United States Steel Corporation as being a wilful misleader of its stockholders. On the contrary, the writer concludes that the United States Steel Corporation's management has tended to be a positive force in disclosure to stockholders and, in general, has chosen accounting methods that lowered net income in the year of the change.

Stockholders

The stockholders of the United States Steel Corporation appeared to be generally indifferent to financial accounting issues at annual meetings.[1] There

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[1]An examination was made of the records of the Annual meetings from 1912 to 1968 in the New York office of the United States Steel Corporation in December of 1968. The first ten annual meetings were not saved by the United States Steel Corporation, but the writer examined the *New York Times* articles on the annual meetings from 1902 to 1911.

were noted in this study two stockholder suits which pertained, partly at least, to financial accounting issues. Both on the valuation issue and on the stock option issue, the Courts held that the stockholders had the very difficult burden of proving management was wrong and that such proof had not been made. The writer concludes that there was enough evidence to indicate that stockholders have not been a major factor in the development of the United States Steel Corporation's statements.

Labor Unions

While labor unions have not been indifferent to financial accounting, they have not been a major factor in the development of the United States Steel Corporation financial statements. Union pressures were brought to bear on such financial accounting topics as wartime reserves during World War II, the amortization of emergency facilities during World War II, the lifo inventory method, price-level depreciation, and accelerated depreciation. In none of these matters were the United States Steel Corporation's financial accounting statements in agreement with labor union views and only in the case of price-level depreciation did the American Institute of Accountants coincide with the

union view. However, labor union interest in the publication of annual pension statements did coincide with the United States Steel Corporation's reporting of such data. The writer concludes that there was sufficient evidence to indicate that while labor unions have exerted pressure in financial accounting, the United States Steel Corporation statements have not been materially shaped by them.

The New York Stock Exchange

The New York Stock Exchange has long been interested in the general area of financial accounting. There was a requirement for companies listed after 1900 to publish annual statements, both balance sheets and income statements. The topics of generally accepted accounting principles and of the auditors' opinion paragraph were issues to which the New York Stock Exchange provided cooperation with the American Institute of Accountants in the 1930's. Since the 1930's the Department of Stock List of the New York Stock Exchange has continued to work for certain major goals in financial accounting. These goals of quarterly reporting, of comparative and consolidated statements, and of the statement of the

sources and uses of funds have largely been achieved.[2] The United States Steel Corporation had consolidated statements in 1902 and a sources and uses of funds statement in its 1902 Annual Report. Comparative Income Accounts were included in the 1903 Annual Report. The New York Stock Exchange has been content to allow older listed companies to continue on their financial accounting path unless a qualified auditor's opinion was present or a material difference was noted between a company's annual report, the company's filings with the New York Stock Exchange, and the company's filings with the Securities and Exchange Commission.[3] The writer concludes that there was sufficient evidence to indicate a significant level of interest in financial accounting by the New York Stock Exchange but that it was not a major factor in the development of the United States Steel Corporation's financial statements, especially in the more recent years.

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[2] Letter from William R. Satterfield, Assistant Director of the Department of Stock List of the New York Stock Exchange, May 27, 1969.

[3] William R. Satterfield, private interview held at the New York Stock Exchange in August of 1969.

Financial Services and Writers

Financial services have provided a basis for which interested parties could examine comparative statements for various companies and a basis by which one could determine the extent of financial accounting disclosure which certain companies made. Financial services stressed the working capital figure and the earnings per share amount long before it was adopted by the United States Steel Corporation. A manager of Dun & Bradstreet stressed the importance of footnote disclosure. An article in Forbes stressed the desirability of uniformity in financial accounting.

Financial writers were important sources on financial accounting matters at the turn of the century. Charles H. Dow stressed the importance of the income statement. Edward Meade recommended an approach for the valuation of the assets of a newly combined trust. Meade also stressed the importance of reserve accumulation and Arthur Stone Dewing provided guidance on such matters as accounting for capital stock transactions. Financial writers also placed emphasis on the working capital figure and the amount of earnings per share and on the utilization of the Surplus Account. Interest was

expressed in the clarification and simplification of annual reports and in the matter of utilization of reserves. The Federation of Financial Analysts in a publication entitled Corporate Reporting for the Professional Investor recommended more disclosure of such items as long-term leases. The writer believes that the stress placed by financial services and writers on certain financial accounting topics probably was a major factor in the eventual inclusion of such items in the annual reports of the United States Steel Corporation.

Federal Government

The interest of the federal government in financial accounting topics was expressed by the United States Industrial Commission, the United States Bureau of Corporations, the Internal Revenue Service, the Federal Reserve Board, Congress, various wartime agencies, and the Securities and Exchange Commission. The United States Industrial Commission stressed the desirability of annual reportings and the dangers of overcapitalization. The United States Bureau of Corporations continued this stress and provided more corporate studies. Both their attempts to get congressional passage of a law requiring

corporate annual reports and prohibiting overcapitalization were successful, but these agencies probably had an influence on the financial climate of their times. The United States Steel Corporation issued annual statements in 1902, was only "moderately" overcapitalized, and de-watered its assets. The Internal Revenue Service established the cost basis for depreciation and at first based the computation of the income tax on the financial accounting records of the corporation. The Internal Revenue Service did not allow financial accounting reserves as tax deductions in either of the world wars.

The modification of the estimated useful lives of assets by the Internal Revenue Service was very quickly adopted by the Accounting Principles Board of the American Institute of Certified Public Accountants for financial accounting purposes. The United States Steel Corporation reclassified its depreciation reserves in line with the Internal Revenue Service viewpoint of depreciation as a function of the cost of the fixed assets. The United States Steel Corporation utilized wartime reserves during both world wars and quickly adopted the revised guidelines lives. The Federal Reserve Board published an uniform set of accounting statements, which did not appear to affect changes in the

United States Steel Corporation's statements until many years later. One can conclude that the interest of the federal government in financial accounting long predated the Securities and Exchange Commission.

Congress expressed some interest in generally accepted accounting principles when it founded the Securities and Exchange Commission. The amortization of the cost of emergency facilities, passed by Congress during World War II and the Korean Conflict, was quickly adopted for financial accounting by the American Institute of Accountants (in World War II), the American Institute of Certified Public Accountants (in the Korean Conflict), and the United States Steel Corporation. Lifo was enacted with a provision that if it were employed for tax purposes, it must also be used for financial accounting purposes. The United States Steel Corporation adopted the lifo method. This was the only case in which the federal government severely limited financial accounting. Congressional passage of accelerated depreciation predated the American Institute of Accountants' acceptance of such methods as double-declining balance and sum-of-the-year-digits. The United States Steel Corporation eventually adopted the double-declining balance method of depreciation for

financial accounting. Congressional interest was noted in the pension fund issue, which may have been a factor in the United States Steel Corporation's presentation of pension statements. Various wartime agencies were interested in financial accounting topics for the purposes of cost justification and pricing, as was the United States Steel Corporation.

The Securities and Exchange Commission has been active in many financial accounting topics. The 1930's witnessed the publication of uniform statements for filing purposes, rules on the segregation and write-down of intangibles, and a study on the reliability of financial accounting audited statements. The United States Steel Corporation revised its income statement to reflect the Securities and Exchange Commission statement form, segregated its intangible fixed assets, but wrote these assets down to a capital surplus account. The auditor's opinion for the United States Steel Corporation in 1939 reflected the changed auditing emphasis. Topics on which the Securities and Exchange Commission issued promulgations were wartime reserves established during World War II and the utilization of such reserves after the War. The United States Steel Corporation utilized wartime reserve accounts during and after the War. The

Securities and Exchange Commission stressed footnote disclosure during this period and the United States Steel Corporation significantly increased its footnotes in its annual reports. The replacement-cost controversy, in which the United States Steel Corporation played a key role, drew the Securities and Exchange Commission disapproval but it approved the accelerated method which the United States Steel Corporation used after dropping the replacement-cost method.

In the 1950's and 1960's, the Securities and Exchange Commission stressed increased disclosure of pension programs, stock option plans, and long-term leases. The United States Steel Corporation did increase its disclosures of these items. The Securities and Exchange Commission asserted its authority in financial accounting in the investment credit controversy and its ruling that financial accounting statements must not be materially different from statements filed with it. The Securities and Exchange Commission can no longer put the onus for the United States Steel Corporation financial accounting reporting solely on the United States Steel Corporation management. If the United States Steel Corporation financial accounting has flaws, the

Securities and Exchange Commission must share in the responsibility for such flaws.

Accounting Forces

From the first topic discussed in this work to the last, accounting writers, public accounting firms, the American Institute of Accountants, the American Institute of Certified Public Accountants, and other accounting bodies have provided guidance on almost all of the financial accounting issues discussed. This guidance culminated with the ruling in Accounting Principles Board Opinion No. 6 that the American Institute of Certified Public Accountants promulgations must be followed or a notation of such fact be made in the auditor's opinion or in a footnote to the statements. The United States Steel Corporation financial accounting statements apparently always were influenced by accounting forces. With the passage of Accounting Principles Board Opinion No. 6, the Accounting Principles Board of the American Institute of Certified Public Accountants has adopted officially the societal responsibility for financial accounting statements. No longer can an undesirable United States Steel Corporation financial accounting event be blamed solely on management of the United States Steel Corporation.

Summary of the Institutional Forces Discussed

In the first chapter the question of "whose statements are they?" was mentioned. While a precise determination of the answer was not attempted by this study, an indication of whose statements they are can be drawn from the work performed. One indication is that stockholders, labor unions, and the New York Stock Exchange were not major factors in the development of the financial statements of the United States Steel Corporation. A second indication is that accounting groups and writers, financial services and writers, and the federal government were major factors in the development of the statements of the United States Steel Corporation. As already mentioned, the management of the United States Steel Corporation also played a very important role in the statements of the United States Steel Corporation.

Implications for Present-Day Financial Accounting

The writer concludes that a rethinking of the orientation of financial accounting should occur. The strong stockholder orientation probably never was a very meaningful one and surely should not be today. The writer thinks that financial accounting should be reoriented toward the financial analyst. It is time to recognize in financial accounting what Ripley stated more than forty years ago.

> . . .The ordinary run of folks are too busy, even were they competent enough. Nor is it true that the primary purposes of publicity, the sharing of full information with owners, is to enable these shareholders to obtrude themselves obsequiously upon their own managements. But such information, if rendered, will at all events serve as fair warning in case of impending danger. And this danger will be revealed, not because each shareholder, male or female, old or young, will bother to remove the wrapping from the annual report in the past, but because specialists, analysts, bankers, and others will promptly disseminate the information, translating it into terms intelligible to all.[4]

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[4]Ripley, Main Street and Wall Street, p. 169.

Considerably more disclosure of financial accounting information would probably occur if financial accountants aimed at meeting the needs of a far more sophisticated person than the average stockholder. While the corporate argument that too much disclosure will benefit competitors may have some validity, it is a calculated risk if financial statements are to meet the needs of various users, including stockholders.

The effect of federal income taxation on financial accounting began with the 1909 corporate tax and continued on after this period with such topics as lifo, amortization of emergency facilities during World War II and the Korean Conflict, stock options, accelerated depreciation, and revised guideline lives. While some may lament the influence of tax accounting on financial accounting, it has been a factor which cannot be assumed away. A determination might be made now as to future American Institute of Certified Public Accountants policy towards changes in tax accounting, in relation to the effect such changes may have on financial accounting.

A very important word in financial accounting is "independence." Statements are audited by independent certified public accountants. However, the American Institute of Accountants-American Institute of Certified

Public Accountants and public accounting firms have lobbied with the federal government for industry on certain issues. In 1917, the American Institute of Accountants lobbied for industry on the matter of price justification on war contracts. Public accounting firms lobbied for the tax acceptance of lifo. During World War II, the American Institute of Accountants lobbied for tax deductibility of wartime reserves. The American Institute of Accountants lobbied for the allowance of the amortization of emergency facilities as a cost for war contract purposes during the Korean Conflict. The American Institute of Accountants lobbied for a more liberal method of depreciation. It is possible in the past that this lobbying may have cast a shadow of doubt on the independence of public accounting firms and the American Institute of Certified Public Accountants from management. Any current or future lobbying may be held to endanger independence and might, on that account, be curtailed.

While the Securities and Exchange Commission and the American Institute of Accountants-American Institute of Certified Public Accountants were to be independent of each other, a close working cooperation was noted. The Securities and Exchange Commission followed the

American Institute of Certified Public Accountants promulgation on wartime reserves and on stock options. The only serious break with the American Institute of Certified Public Accountants occurred with the investment credit issue. It would be misleading for those interested in financial accounting to assume that an independent relationship between the Securities and Exchange Commission and the American Institute of Accountants-American Institute of Certified Public Accountants existed or exists.

The problems associated with the watered stock at the turn of the century, in terms of the amount of asset valuation, create doubt as to the wisdom of adopting an accounting policy of periodic revision of the valuation of fixed asset on the balance sheet. The possibility of public accountants being able to control management in this area does not appear to have been borne out by the events at the turn of the century.

The American Institute of Accountants-American Institute of Certified Public Accountants was not always successful in obtaining the United States Steel Corporation's compliance with formal promulgations in the days when such promulgations did not carry the sanction which they now have. One example of this was the write-down of intangibles to a capital surplus account in 1938. The use of the United States Steel

Corporation of its wartime reserve for the write-off of emergency facilities, for the 1946 strike cost, and for increased inventory cost signified quite well the ability of management to oppose Accounting Research Bulletins. The pension cost controversy in 1958 also illustrated the weakness of the American Institute of Certified Public Accountants when management was concerned with portraying a better net income figure. Whether one agrees with the currently stronger stand taken by the American Institute of Certified Public Accountants in regards to Accounting Principles Board Opinions, he can note the past failures in obtaining a uniform method of handling certain transactions when the authority of American Institute of Accountants-American Institute of Certified Public Accountants promulgation depended only upon their general acceptability. Some greater compulsion than general acceptability was probably needed but how far to go is another question to decide. For instance, the more rigid rules of the Accounting Principles Board of the American Institute of Certified Public Accountants may hamper corporations in their experimenting with financial accounting. Would the United States Steel Corporation in 1968, for example, have issued statements which employed the replacement-cost approach for depreciation accounting

as it did in 1947? The 1947 Annual Report spurred much discussion and institutional rulings. The lack of freedom to present a radical departure in the annual financial statements may prevent such experimentation now and in the future.

It is conceivable that the yearly depreciation expense estimated by engineers may yield a much more meaningful financial accounting depreciation figure than depreciation amounts based on taxation methods. For instance, the use of the double-declining balance method in a year in which there was considerable fixed asset procurement and relatively little production would yield an expense amount undoubtedly much greater than an engineering estimate of depreciation. Might not, in that case, the depreciation expense amount estimated by engineering-oriented persons yield a net income figure which has more meaning than a net income figure computed by the double-declining balance method?

One of the oft-quoted generalizations in financial accounting is that it was not until the 1930's that the income statement began to receive increased emphasis over the balance sheet. This study indicated evidence that the income figure was a calculation of prime importance at the turn of the 20th century to

financial services and writers, to the New York Stock Exchange, the United States Industrial Commission, to public accounting firm of Price, Waterhouse & Company, and to an accounting writer, George Lisle. Financial services provided income figures, when reported by corporations, to investors and a financial writer, Charles H. Dow, stressed the importance of the income figure. The New York Stock Exchange required the publication of a yearly income statement for corporations joining the exchange after 1900. The United States Industrial Commission recommended that a profit and loss statement be published annually. The senior partner of Price, Waterhouse & Company, and other accounting writers pointed out the significance of the income figure. An assertion that the income statement was of secondary importance to the balance sheet in financial accounting before the 1930's should not be readily accepted as being accurate.

Perhaps the most interesting finding to the writer was the stage of development of financial accounting at the turn of the 20th century, in relation to what the writer had expected to find. Examples of this stage were the very detailed annual reports of the United States Steel Corporation, the reports of the

United States Industrial Commission, and the United States Bureau of Corporations, Poor's Manual, the accounting and financial literature of the time, and the interest of the New York Stock Exchange in annual reporting. It may be that the crystalization[5] of financial accounting principles into financial accounting practices did not occur in the 1930's. However, both financial accounting theory and practice were much better developed at the turn of the 20th century than is commonly believed.

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[5] Hendricksen, Accounting Theory, p. 50.

APPENDIX

APPENDIX FOR CHAPTER II

TABLE 1

INCOME ACCOUNT FOR 1902

The total net earnings of all properties after deducting expenditures for ordinary repairs and maintenance (approximately $21,000,000), also interest on Bonds and fixed charges of the subsidiary companies, amounted to		$133,308,763.72
Less: Appropriation for the following purposes, viz:		
Sinking funds on Bonds of Subsidiary Companies	$ 624,064.63	
Depreciation and Extinguishment funds (regular provisions for the year)	4,834,710.28	
Extraordinary Replacement funds (regular provision for the year)	9,315,614.76	
Special fund for Depreciation and Improvement	10,000,000.00	24,774,389.47
Balance of Net Earnings for the year		$108,534,374.25

TABLE 1 (continued)

Deduct:		
Interest on U. S. Steel Corporation Bonds for the year	$15,187,850.00	
Sinking fund on U. S. Steel Corporation Bonds for the year	3,040,000.00	18,227,850.00
Balance		$ 90,306,524.25
Dividends for the year on U. S. Steel Corporation Stocks, viz:		
Preferred, 7 per cent	$35,729,177.50	
Common, 4 per cent	20,332,690.00	56,052,867.50
Undivided Profit or Surplus for the Year		$ 34,253,656.75

TABLE 2

PROFIT AND LOSS ACCOUNT FOR 1902

Year Ending December 31, 1902

GROSS RECEIPTS		
Gross Sales and Earnings		$560,510,479.39
MANUFACTURING AND OPERATING EXPENSES		
Manufacturing and Producing Cost and Operating Expenses		411,408,818.36
Balance		$149,101,661.03
Miscellaneous Manufacturing and Operating Gains and Losses (Net)	$2,654,189.22	
Rentals Received	474,781.49	3,128,970.71
Total Net Manufacturing, Producing and Operating Income		$152,230,631.74
OTHER INCOME		
Proportion of Net Profits of properties owned but whose operations (gross revenue, cost of product, expense, etc.) are not included in this statement	1,972,316.45	
Interest and Dividend on Investments and on Deposits, etc.	3,454,135.50	5,426,451.95
Total Income		$157,657,083.69

TABLE 2 (continued)

GENERAL EXPENSES		
Administrative, Selling and General Expense (not including General Expense of Transportation Companies)	$13,202,398.89	
Taxes	2,391,465.74	
Commercial Discounts and Interest	1,908,027.90	17,501,892.53
		$140,155,191.16
INTEREST CHARGES, ETC.		
Interest on Bonds and Mortgages of the Subsidiary Companies	$ 3,879,439.91	
Interest on Bonds Payable	2,234,144.13	
Rentals Paid	732,843.10	6,846,427.44
Net Earnings for the Year		$133,308,763.72

TABLE 3

VALUATION SCHEDULE FOR 1902

Assets	Valuation	Principles governing Valuation
1. Iron and ore properties	$700,000,000	1. Properties cannot be duplicated at any price. 2. Yield direct profit of $30,000,000 on present price of ore. 3. The Steel Corporation would be compelled to pay $700,000,000 in order to obtain these deposits.
2. Plants, mills, fixtures, machinery, equipment, tools, and real estate	300,000,000	1. Impossibility of duplicating these mills for a less amount. 2. The mills are necessary to make the profits of the corporation, stated to be at the rate of $140,000,000 per year.
3. Coal and coke fields (87,589 acres)	100,000,000	1. Net profits to the corporation, based on the present prices of coal and coke, over $12,000,000.
4. Transportation properties	80,000,000 (after deducting $40,340,000 of bonded debt)	1. Cost of duplication. 2. Profits of mills $10,000,000 because of possession of transportation facilities.

TABLE 3 (continued)

Assets	Valuation	Principles governing Valuation
5. Blast furnaces	48,000,000	1. Cost of duplication.
6. Natural gas fields	20,000,000	1. Profit of $2,000,000.
7. Limestone properties	4,000,000	1. Cost of duplication. 2. Profit of $500,000.
8. Cash and cash assets	214,278,000	1. Cash assets valued at cost.

Meade, "The United States Steel Corporation's Bond Conversion," 42.

TABLE 4

UNITED STATES STEEL CORPORATION AND SUBSIDIARY COMPANIES

SUMMARY OF FINANCIAL OPERATIONS OF ALL PROPERTIES

Year Ending December 31, 1902

Showing the Net Resources for the Year and Disposition Thereof

RESOURCES

Profit and Loss Surplus for the year, per Income Account, page 6			$34,253,656.75
Net Receipts appropriated from Earnings for Bond Sinking, Depreciation and Improvement Funds (see Income Account, page 8)		$27,814,389.47	
Less: Payments therefrom to Trustees of Bond Sinking Funds	$3,604,064.43		
Expended for Extraordinary Replacement	7,926,792.60	11,530,857.03	
		$16,283,532.44	
Net Receipts account Insurance and Contingent Funds during the year		804,319.35	
Balance of Receipts for Year included in Fund accounts			17,087,851.79
Bonds and Mortgages issued			2,370,338.35
Sundry Miscellaneous Receipts			5,920.98
Total Net Resources			$53,717,767.87

TABLE 4 (continued)

PAYMENTS MADE FROM ABOVE		
Expended for Additional Property and Construction, per page 15	$16,586,531.77	
Bonds and Mortgages paid (not including bonds redeemed with sinking funds)	1,697,577.33	
Purchase Money Obligations, Bills Payable and Special Deposits paid off	13,652,367.94	31,936,477.04
Balance of Net Resources for the year, accounted for as below		$21,781,290.83
INCREASE IN CURRENT ASSETS, VIZ:		
In Sundry Securities and Investments	$ 3,193,604.83	
In Accounts and Bills Receivable in excess of increase in Accounts Payable	9,595,635.15	
In Inventories and Miscellaneous Accounts	12,625,946.02	
	$25,415,186.00	
Less: Decrease in Cash on Hand December 31, 1902, as compared with preceding year	3,633,895.17	
Balance as above	$21,781,290.83	

APPENDIX FOR CHAPTER III

TABLE 1

UNDIVIDED SURPLUS ACCOUNT, DECEMBER 31, 1904

Surplus or Working Capital provided in organization		$25,000,000.00
Balance of Surplus Accumulated from April 1, 1901, to December 31, 1903, per Annual Report for Year 1903, exclusive of the amount of $10,371,803.25, transferred January 1, 1904, in connection with inauguration of new accounting plan adopted as of that date, to separate surplus account as shown below	$30,724,879.11	
Less: adjustments in sundry account in 1904	31,516.80	30,693,362.31
Undivided Profits of all companies for the year 1904		5,047,852.19
		$60,741,214.50

Less: Charged off on December 31, 1904, by authority of the Board of Directors, for expenditures made from Surplus for construction and payment of capital liabilities (see page 21), viz:

TABLE 1 (continued)

Expenditures made during the year 1904	$ 5,563,985.61	
Expenditures made during the previous years	2,929,249.87	8,493,235.58
Balance of Undivided Surplus, December 31, 1904 exclusive of subsidiary companies' Intercompany profits in inventory		$52,247,978.92
Undivided Surplus of subsidiary companies representing profit accrual on sales of materials to other subsidiary companies, and on hand in latter's inventories, viz:		
Balance on December 31, 1903, transferred as above	$10,371,803.25	
Less: Decrease during the year 1904	1,254,336.48	9,117,466.77
Total Undivided Surplus, December 31, 1904		$61,365,445.69

TABLE 2

CONSTRUCTIVE BALANCE SHEET OF STEEL CORPORATION, 1901-1910, ESTABLISHED BY SUBSTITUTING BUREAU'S VALUATION OF FIXED PROPERTY FOR CORPORATION'S BOOK VALUATION OF SUCH PROPERTY

ASSETS

	Apr. 1, 1901	Dec.31, 1901	Dec.31, 1902	Dec.31, 1910
Property account brought forward	-	$ 545,500,000	$ 554,904,482	$ 880,147,299
Fixed property additions capitalized	-	16,680,384	47,981,699	55,067,584
	-	562,180,384	602,886,181	935,214,883
Estimated true depreciation	-	11,546,368	16,895,812	27,687,195
Less property expenditures not capitalized	-	4,270,466	7,679,519	9,777,713
Net outstanding or accrued depreciation	-	7,275,902	9,216,293	17,909,482
Net property account	$ 545,500,000	554,904,482	593,669,888	917,305,401
Deferred charges to operations	2,088,027	1,737,456	1,633,391	15,331,705
Investments	241,030	3,871,954	1,874,872	2,369,394
Sinking and reserve fund assets	239	245,319	1,388,862	16,067,905
Inventories	71,852,439	92,325,938	104,370,845	176,537,824
Accounts receivable	50,910,861	40,606,458	48,944,190	44,603,273
Agents' balances	-	-	1,091,319	696,834
Bills receivable	3,280,190	3,121,320	4,153,291	5,540,181
Stocks and bonds	10,168,824	3,765,400	6,091,340	4,410,794
Cash	56,153,066	52,471,147	50,163,173	56,953,514
Total tangible assets	740,194,676	753,049,474	813,401,171	1,239,816,825
Intangible considerations and water	721,328,839	699,929,211	625,569,473	281,671,574
Total	1,461,523,515	1,452,978,685	1,438,970,644	1,521,488,399

TABLE 2 (continued)

LIABILITIES

	Apr. 1, 1901	Dec.31, 1901	Dec.31, 1902	Dec.31, 1910
Capital stock:				
Preferred	$ 510,205,743	$ 510,205,743	$ 510,281,100	$ 360,281,100
Common	508,227,394	508,227,394	508,302,500	508,302,500
Unacquired stock of subsidiary companies. . . .	535,407	557,378	215,914	602,352
Outstanding bonded and debenture debt.	362,541,657	362,681,214	360,754,327	596,351,867
Mortgages and purchase-money obligations	21,872,023	17,127,238	9,590,551	3,097,793
Total capital liabilities	1,403,382,224	1,398,798,967	1,389,144,392	1,468,653,612
Accounts payable.	27,466,680	18,400,156	19,726,686	30,485,091
Bills payable	17,134,803	12,064,047	6,202,502	813,500
Special amounts due employees and others. . . .	7,622,490	5,253,356	4,485,547	886,122
Accrued interest and unpresented coupons	5,917,318	4,450,893	5,398,573	7,991,373
Preferred-stock dividends payable	-	8,928,992	8,929,919	6,304,919
Common-stock dividends payable		5,082,274	5,083,025	6,353,782
Total current liabilities	58,141,291	54,179,718	49,826,252	52,834,787
Total capital and current liabilities	1,461,523,515	1,452,978,685	1,438,970,644	1,521,488,399

U. S., Bureau of Corporations, Report of the Commissioner of Corporations on the Steel Industry, Part I, p. 328.

TABLE 3

COMPARATIVE INCOME ACCOUNT FOR THE FISCAL YEARS ENDING DECEMBER 31, 1903 AND 1902

	1903	1902	Increase or Decrease	
NET EARNINGS	$109,171,152.35	$133,308,763.72	$24,137,611.37	Dec.
Less: Appropriations for the following properties, viz:				
Sinking Funds on Bonds of Subsidiary Companies	1,598,012.48	624,064.43	973,948.05	Inc.
Depreciation Extinguishment, Extraordinary Replacement, Improvement and Construction Funds	23,897,353.36	24,150,325.04	252,971.68	Dec.
Balance of Net Earnings for the year	$ 83,675,186.51	$108,534,374.25	$24,858,587.74	Dec.
Deduct:				
Interest on U.S. Steel Corporation Bonds	19,082,796.38	15,187,850.00	3,894,946.38	Inc.
Sinking Funds on U.S. Steel Corporation Bonds	3,797,500.00	3,040,000.00	757,500.00	Inc.
	$ 60,795,490.13	$ 90,306,524.25	$29,511,034.12	Dec.
Less: Charged off for depreciation in inventory valuations and for the adjustment of sundry accounts	5,378,837.63	-	5,378,837.63	Inc.
Balance	$ 55,416,652.50	$ 90,306,524.25	$34,889,871.75	Dec.
Dividends on U.S. Steel Corporation stocks, viz:				
Preferred 7%	30,404,173.41	35,720,177.50	5,316,004.09	Dec.
Common 2½% in 1903, 4 % in 1902	12,707,562.50	20,332,690.00	7,625,125.50	Dec.
Undivided Profits or Surplus	$ 12,304,916.50	$ 34,253,656.75	$21,948,740.10	

TABLE 4

UNITED STATES STEEL CORPORATION AND SUBSIDIARY COMPANIES
CONDENSED GENERAL PROFIT AND LOSS ACCOUNT
For year ending December 31, 1908

GROSS RECEIPTS: Gross Sales and Earnings (see page 25)		$482,307,840.34
Operating Charges, viz:		
Manufacturing and Producing Cost and Operating Expenses, including ordinary maintenance and repairs and provisional charges for depreciation	$384,700,283.73*	
Administrative, Selling and General Expenses, and Employes' Bonus Funds (not including general expenses of transportation companies)	12,932,696.13	
Taxes	5,361,160.20	
Commercial Discounts and Interest.	2,707,181.06	
	$405,701,321.12	
Less: Amount included in above acharges for provisional reserves for depreciation now deducted for purpose of showing the same in separate item of charge, as see below	16,965,181.46	388,736,139.66
Balance.		$ 93,571,700.68
Sundry Net Manufacturing and Operating Gains and Losses including Idle Plant expenses, Royalties received, Depreciation in inventory valuations, etc.	$ 628,194.92	
Rentals received	860,610.13	1,488,805.05
Total Net Manufacturing, Producing and Operating, Income before deducting provisional charges for depreciation.		$ 95,060,505.73
OTHER INCOME		
Net Profits of Properties owned, but whose operations (gross revenue, cost of product, expenses, etc.) are not included in this statement	$ 520,641.23	
Interest and Dividends on Investments and on Deposits,etc.	3,777,438.73	4,298,079.96
Total		$ 99,358,585.69

TABLE 4 (continued)

INTEREST CHARGES

Interest on Bonds and Mortgages of the Subsidiary Companies	$7,189,491.50	
Interest on Purchase Money Obligations and Special Deposits or Loans of the Subsidiary Companies	211,713.68	7,401,205.18
Balance, being the aggregate earnings of the several companies for the year before deducting provisional charges for depreciation.		$91,957,380.51
Less: Net Balance of Profits earned by subsidiary companies on sales made and service rendered account of materials on hand at close of year in purchasing companies' inventories, and which profits have not yet been realized in cash from the standpoint of a combined statement of the business of the U.S. Steel Corporation and subsidiary companies.		109,664.94
Earnings for the Year 1908, per Income Account, page 32		$91,847,710.57
Less: Appropriations for various Depreciation Funds		16,965,181.46
Net Earnings in the year 1908		$74,882,529.11

*Includes charges for ordinary maintenance and repairs, approximately $27,000,000. See table on page 9.

APPENDIX FOR CHAPTER IV

TABLE 1

SURPLUS OF UNITED STATES STEEL CORPORATION AND SUBSIDIARY COMPANIES
(Since April 1, 1901)

Balance of Undivided Surplus, December 31, 1928, exclusive of Profits earned by subsidiary companies on inter-company sales of products on hand in inventories, per Annual Report for 1928. .		$410,277,349.27
Add: Surplus Net Income earned in year 1929, per Income Account, page 1 .		108,523,342.99
Refunds received in 1929 of Federal Income and Excess Profits Taxes of earlier years		15,756,595.72
Balance of Inventory Reserve originally provided to absorb deflation in values because of post-war economic adjustment, now transferred to Surplus		47,076,404.12
Reserve set aside to provide against possible failure to realize Mining Royalties on unmined iron ore from specific properties now transferred to Surplus, being no longer required for that purpose . .		7,000,000.00
		$588,633,692.10
Less: Charges to and Appropriation of Surplus:		
Premium and unamortized discount on Bonds of United States Steel Corporation and subsidiary companies retired and called for redemption during the year . .	$40,626,544.25	
Surplus appropriated for amortization of appreciated cost to U.S. Steel Corporation of its investment in capital stocks of Subsidiary Companies in excess of their investment in tangible property	88,296,020.00	
Capital provided in organization (in 1901) and heretofore carried in "Surplus" account written off in reduction of Property Investment Account	25,000,000.00	153,922,574.34
Balance of Earned Undivided Surplus, December 31, 1929, exclusive of Profits earned by subsidiary companies on inter-company sales of products on hand in inventories		$434,711,117.76

APPENDIX FOR CHAPTER V

TABLE 1

UNITED STATES STEEL CORPORATION AND SUBSIDIARY COMPANIES
COMPARATIVE CONSOLIDATED STATEMENT OF INCOME AND SURPLUS
FOR THE YEAR ENDING DECEMBER 31, 1936 AND 1935

	Year 1936	Year 1935
GROSS SALES AND REVENUE (EXCEPT REVENUE FROM TRANSPORTATION OPERATIONS)		
Sales to Domestic and Export Customers	$744,359,021.75	$505,155,306.10
Gross Revenue from Miscellaneous Operations	21,737,987.05	14,902,722.09
	766,097,008.80	520,058,028.19
Sales between Subsidiaries for Conversion Uses and Resale	225,587,718.05	174,068,503.13
Total	991,684,726.85	694,126,531.32
GROSS REVENUE FROM TRANSPORTATION OPERATIONS (RAIL AND WATER)	97,544,280.14	64,766,594.55
Gross Sales and Revenue from All Sources	1,089,229,006.99	758,893,125.87
Less: Commercial Discounts on Sales	5,891,571.68	4,379,036.86
Gross Sales and Revenue	1,083,337,435.31	754,514,089.01
COST OF ALL GOODS SOLD AND OPERATING EXPENSES OF TRANSPORTATION AND MISCELLANEOUS OPERATIONS	872,517,488.57	623,446,398.06
Balance	210,819,946.74	131,067,690.95
OTHER OPERATING CHARGES		
General Administrative and Selling Expenses	40,827,619.43	34,898,497.39
Payments under Pension Plan to U.S. Steel and Carnegie Pension Fund	7,642,025.86	7,362,722.82
Taxes (other than Federal Income and Social Security Taxes)	37,999,606,18	34,691,330.19
State and Federal Social Security and Railroad Retirement Tax Provisions	4,081,587.18	-
Idle Plant Expenses	1,396,989.36	2,089,258.73
Allowances for Depletion, Depreciation and Obsolescence.	56,818,589.12	47,633,729.78
	148,766,417.13	126,675,538.91
Operating Income	62,053,529.61	4,392,152.04

TABLE 1 (continued)

		Year 1936	Year 1935
OTHER INCOME			
Dividends from Outside Investments		555,650.91	360,494.17
Interest on Outside Securities and Sundry Accounts (net)		1,182,343.79	2,487,905.62
Discount on Purchases		1,455,168.78	939,640.68
Net Profit on Marketable Securities Disposed of		70,612.95	236,196.47
Rentals and Royalties Received		1,667,625.22	1,688,912.79
Sundry Credits and Charges (net)		185,612.71	317,335.58
		67,170,543.97	10,422,637.35
OTHER DEDUCTIONS			
Net Loss on Sales of Capital Assets		439,230.03	371,396.99
Minority Proportion of Profits of Companies not Wholly Owned		29,526.75	19,752.31
		66,701,787.19	10,031,488.05
INTEREST CHARGES ON FUNDED DEBT			
Of Subsidiary Companies		4,904,980.79	4,946,329.74
Of United States Steel Corporation		13,450.00	13,450.00
Net Income before Charging Federal Income Taxes		61,783,356.40	5,071,708.31
PROVISIONS FOR FEDERAL INCOME, EXCESS PROFITS AND UNDISTRIBUTED PROFITS TAXES		11,200,000.00	3,925,000.00
Net Income Available for Dividends		50,583,356.40	1,146,708.31
DIVIDENDS ON U.S. STEEL CORPORATION PREFERRED STOCK			
Regular 7% for 1936	$25,219,677.00		
Paid in 1936 on arrearages 7%	25,219,677.00	50,439,354.00	(2%)7,205,622.00
Surplus for Year		144,002.40	6,058,913.69*
Undivided Surplus at Close of Previous Year		252,516,714.19	258,575,627.88
BALANCE OF EARNED UNDIVIDED SURPLUS at December 31 (exclusive of profits earned by subsidiary companies on inter-company sales of products on hand in inventories) per Balance Sheet		$252,660,716.59	$252,516,714.19

*Deficit

FIGURE 1

HOW THE CORPORATION EARNED

ITS LIVING IN 1939

	Total Amount (Millions of Dollars	Per Cent of Total	Total Amt. Per Employe
U.S. STEEL SOLD TO THE PUBLIC GOODS & SERVICES	$857	100.0	$3,829
This revenue was disposed of as follows:			
GOODS & SERVICES PURCHASED FROM OTHERS.	$310	36.2	$1,384
WEAR & USAGE OF FACILITIES (Depletion&Depreciation)	61	7.1	274
TAXES.	67	7.8	299
INTEREST PAID (for the use of savings, the ownership of which is evidenced by outstanding bonds and other obligations)	9	1.1	42
LEAVING FOR WAGES FOR THE SERVICES OF MEN AND FACILITIES	410	47.8	1,830
This was disposed of as follows:			
WAGES AND SALARIES FOR MEN (being 90%).	369		
WAGES FOR THE USE OF FACILITIES	41		

This was equal to a wage of 3.0% for the use of tools in the form of plants, facilities, equipment and other assets essential to the production and sale of goods and services and the payment of wages and salaries. These tools or assets represented savings, the ownership of which is evidenced by outstanding preferred and common stock.

FIGURE 1 (continued)

	Total Amount (Millions of Dollars
This wage was disposed of as follows:	
TO THE HOLDERS OF PREFERRED STOCK	25
SET ASIDE FOR FUTURE NEEDS.	16

(This is a rearranged approximate statement of the Corporation's financial activities--for formal statement, see pages 16, 17, & 18.)

FIGURE 2

BALANCE SHEET IN CHART FASHION

	thousands of dollars
Miscellaneous Assets, etc. . .	70,490
Amounts owed us by customers	95,773
Cash, etc., to pay wages and bills	185,511
Value of products on hand and for conversion for sale	294,593
Plants and working properties (after allowance for wear and use)	1,122,157
TOTAL	$1,768,524

	thousands of dollars
We had bills to be paid . .	143,889
We had long-term debt . . .	216,502
Savings invested by preferred stockholders. .	360,281
Balance--representing common stockholders' investments and savings	1,047,852
TOTAL	$1,768,524

BALANCE DECEMBER 31, 1939

APPENDIX FOR CHAPTER VI

TABLE 1

CONSOLIDATED STATEMENT OF INCOME

	Year 1942	Year 1941
SALES AND REVENUES		
Sales and revenues, less discounts, returns, allowances and bad debts	$1,861,940,280	$1,617,410,003
Interest, dividends and other	4,011,412	4,945,919
TOTAL	1,865,951,692	1,622,355,922
COSTS		
Employment costs:		
Wages and salaries. . .	725,750,899	590,233,976
Social security taxes .	24,245,901	22,856,726
Payments for pensions (details on page 16).	32,664,901	15,184,433
	782,661,701	628,275,135
Purchased products and services.	648,401,343	579,640,279
Depletion and depreciation.	91,765,371	80,756,339
Amortization of emergency facilities.	31,962,146	9,948,140
Loss on sale of fixed assets.	4,434,013	1,885,708
Estimated additional costs applicable to this period arising out of war.	25,000,000	25,000,000
Interest and other costs on long-term debts. .	6,153,392	6,033,398
State, local and miscellaneous taxes .	48,255,157	49,945,848
Estimated Federal taxes on income	155,500,000	118,700,000
TOTAL	1,794,133,123	1,506,184,847

TABLE 1 (continued)

	Year 1942	Year 1941
INCOME	71,818,569	116,171,075
DIVIDENDS--On cumulative preferred stock ($7.00 per share)	25,219,677	25,219,677
On common stock ($4.00 per share)	34,813,008	34,813,008
CARRIED FORWARD FOR FUTURE NEEDS	$ 11,785,884	$ 56,138,390

TABLE 2

NOTES TO ACCOUNTS

Renegotiation of Government Contracts. War profits control legislation gives the Government the right under certain conditions to renegotiate and adjust profits realized on contracts and subcontracts with resulting reduction in and refunding of profits realized on such contracts. Because of the uncertainties involved, it is impossible to estimate at this time the effect, if any, of such renegotiation upon the financial statements of the Corporation and its subsidiaries.

Basis for Federal Tax Provisions. The final liability for Federal income taxes for the years 1930, and 1935 through 1941, has not yet been determined. The Revenue Act of 1942 contains many provisions, including relief provisions, upon which various interpretations can be placed and it will be some time before its ultimate effect can be determined. Although additional taxes may be levied for these years, it is believed that reasonable reserves have been provided.

Depreciation and Amortization. Special amortization allowances for emergency facilities are computed over a period not in excess of five years and are subject to

adjustment if the emergency terminates before the end of that period. Provision for depreciation of other facilities is being made to meet the added burden on plant and equipment resulting from pressure to secure maximum production.

Estimated Additional Costs Arising Out of War. For the year 1942, as in the year 1941, a reserve of $25,000,000 was provided for those costs applicable to this period arising out of war and which because of the high rate of operations must be deferred until a future time, as well as for transition to a peace-time basis at the end of the war.

Inventories. At December 31, 1942, certain inventories are carried at cost or market, whichever is lower, and certain others are carried at cost as determined under the last-in, first-out inventory method. As outlined in the annual report for 1941, the last-in, first-out inventory method was adopted at January 1, 1941, and was made applicable to certain materials. This method was extended to certain other materials in 1942, resulting in a reduction in inventories at December 31, 1942, and in income before calculating Federal taxes for the year 1942, of approximately $1,500,000 as compared with the method followed in 1941. Inventories at December 31, 1942, included cost, less billings, of contracts in progress of

$28,475,595 as compared with $8,858,739 at December 31, 1941.

Fixed Asset Valuation. The gross values at which the tangible property, plant and equipment are carried in the consolidated balance sheet have been determined from and based upon the findings of the United States Bureau of Corporations, and accepted by the Bureau of Internal Revenue of the Treasury Department, as at the initial date of organization of the Corporation, plus actual cost of additions since, and less credits for the cost of properties sold, retired or otherwise disposed of.

Insurance Reserves. Although, in view of the present emergency, outside insurance against fire, windstorm, marine, war damage and related losses has been placed on a substantial part of the subsidiary companies' insurable assets, the balance in the reserve for insurance at December 31, 1942, is held available for absorbing possible losses of this character in connection with properties not so insured and for other emergencies.

Basis of Consolidation. The consolidated balance sheet and the statements of accounts present the combined results for United States Steel Corporation and subsidiaries for the year ended December 31, 1942. In these statements, inter-company accounts and inter-company profit in inventories of the subsidiary companies have been

eliminated. The effect on the consolidated balance sheet and related income account of the exchange situation with respect to investment in foreign assets and the earnings from foreign transactions is not material.

APPENDIX FOR CHAPTER VIII

TABLE 1

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TABLE 2

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BIOGRAPHICAL SKETCH

Richard G. J. Vangermeersch was born October 7, 1940, at Providence, Rhode Island. In June, 1957, he was graduated from North Providence High School and was awarded the school's social science scholarship grant. He was also a member of the Rhode Island Honor Society. In August, 1959, he received the degree of Bachelor of Science in Accounting from Bryant College. While attending Bryant College, he was awarded a Bryant District Scholarship. From 1959 until 1962, he was employed as a public accountant and as an industrial accountant. During this time he also attended various evening extensions and received enough credits to obtain a Liberal Arts Certificate from the University of Rhode Island Extension Division. In 1962 he enrolled in the Graduate School of the University of Rhode Island. He worked as a graduate assistant in the Department of Accounting until June, 1964, when he received the degree of Master of Science. He was then employed as an accountant and auditor by the U. S. General Accounting Office in Washington, D. C., until September of 1965, when he entered the Graduate School of the University of Florida. He attained the CPA

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This dissertation was prepared under the direction of the chairman of the candidate's supervisory committee and has been approved by all members of that committee. It was submitted to the Dean of the College of Business and to the Graduate Council, and was approved as partial fulfillment of the requirements for the degree of Doctor of Philosophy.

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